Quarterly Economic Update

August 24, 2010

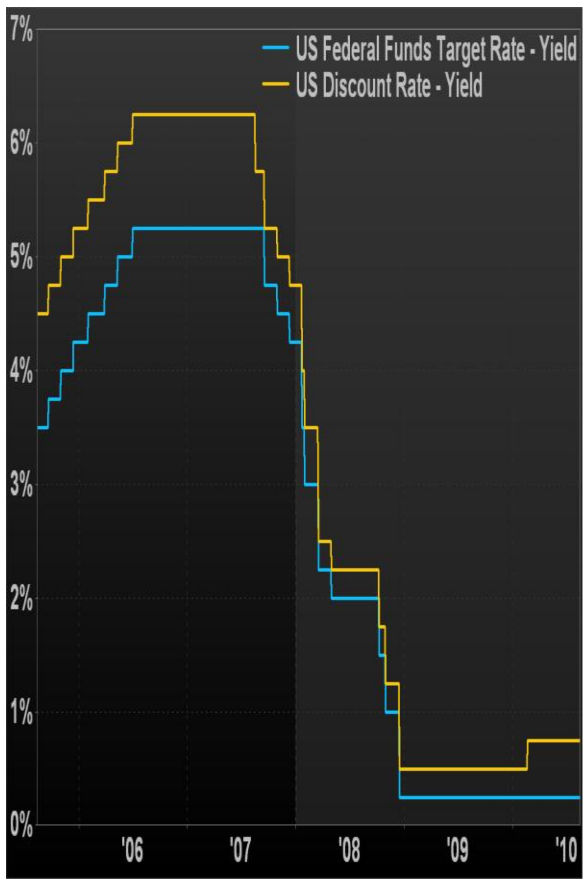
MACROECONOMIC COMMENTARY

Monetary Policy

By Bobby Long

After spending much of the first half of the year discussing exit strategies and how to go about removing policy accommodation, the Federal Open Market Committee (FOMC) has now found themselves considering ways to provide additional stimulus as needed to support the faltering economic recovery. The FOMC has optimistically looked ahead after a major recession and strain in financial markets. They began easing monetary policy almost three years ago and have maintained accommodative policy as financial markets have stabilized and the economy has shown some signs of improvement. As some economic indicators have shown a turn in a more positive direction, the FOMC has breathed a sigh of relief and shifted focus towards how they will tighten policy as an economic recovery develops. While they have been cautiously optimistic, they have maintained we were proceeding with a recovery. More recently, as some economic indicators have shown weakness, they have acknowledged that the economic recovery has stumbled somewhat and must be careful not to move forward too quickly with a change in monetary policy.

The federal funds target rate remains at a historical low of 0 to ¼ percent, where the FOMC has maintained it "continues to anticipate that economic conditions . . . are likely to warrant exceptionally low levels of the federal funds rate for an extended period." They have held the discount rate at a ½ percent spread over the federal funds target rate. The FOMC seems committed to keep this target rate at these low levels for some time, barring a significant uptick in economic conditions and inflation expectations. Many economists and market participants now expect the target rate to remain at these levels well into 2011. When the FOMC does feel that economic conditions warrant an increase in the federal funds target rate, they are expected to communicate the move well in advance through changes to the wording of their statement as well as through speeches and testimony from FOMC members.



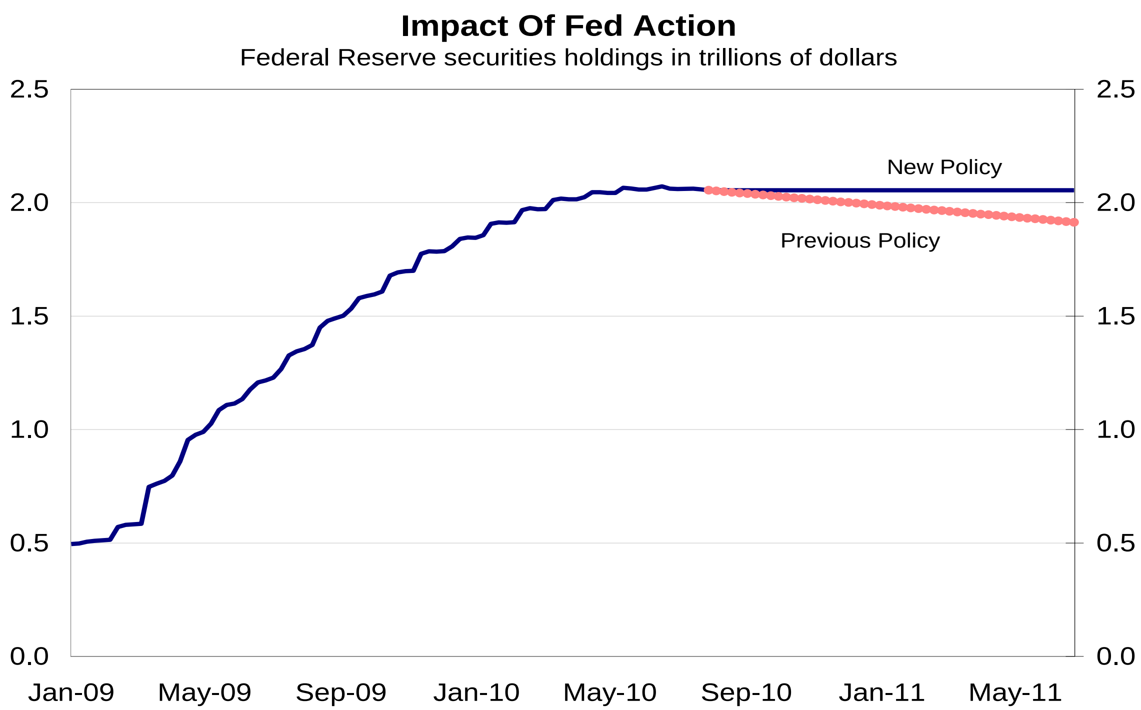
Source: Factset Research Systems

The June 23rd FOMC meeting went by with no change in policy and little change in their official outlook. Their official statement regarding the economic recovery and growth was slightly weakened, acknowledging that "financial conditions have become less supportive of economic growth on balance, largely reflecting developments abroad." They also acknowledged that underlying inflation had trended lower and repeated their expectations that "inflation is likely to be subdued for some time." The minutes revealed discussion regarding asset sales and varying opinions about how and when to begin actively shrinking the size of the Federal Reserve's balance sheet and reducing the amount of securities held. The minutes indicated some members advocated beginning asset sales in the near term, while others remained concerned that asset sales would begin tightening financial conditions too soon in a still recovering economy. Some concerns were expressed as to whether asset sales should proceed ahead of increasing short-term interest rates. The majority of members seemed to agree that it was too soon to shift policy through asset sales especially in light of the recent modest weakening in economic conditions.

Federal Reserve Chairman Ben Bernanke submitted his Semiannual Monetary Policy Report to the Congress on July 21, 2010. In his testimony, he repeated the FOMC's expectations of "moderate growth, a gradual decline in the unemployment rate, and subdued inflation over the next several years." He noted that the outlook and pace of economic activity had weakened somewhat recently, and that risks to the economic recovery had increased with greater uncertainty about the outlook for growth and unemployment. While providing a slightly weaker outlook, Chairman Bernanke continued to discuss how the Federal Reserve would begin removing accommodative policy as the economic recovery proceeded. He stated FOMC participants "broadly agree" that agency and MBS securities should be sold at some point to remove stimulus and reduce the size of the Federal Reserve's balance sheet. Although he spent much of his time discussing how the Federal Reserve would remove policy, he did acknowledge that the committee recognizes that the economic outlook remains unusually uncertain in an attempt to provide flexibility for future policy actions.

At the August 10th meeting, the FOMC statement communicated a weaker near term outlook through even weaker language than the prior statement reflecting an increased concern about the pace of recovery in output and employment. They noted that the "pace of economic activity is likely to be more modest in the near term than had been anticipated" and indicated a more widespread decline in inflation. Again there was no change to the federal funds target rate, but the committee announced they would begin reinvesting maturities and principal prepayments from agency debt and agency mortgage-backed securities in longer-term Treasury securities. Prior to this meeting, maturities and principal payments from agency debt and agency mortgage-backed securities were not being reinvested, resulting in a gradual decline in the level of securities held on the Federal Reserve's balance sheet. They later released a statement that these reinvestments would be made in the two to ten year Treasury range. They will also continue to reinvest Treasury maturities.

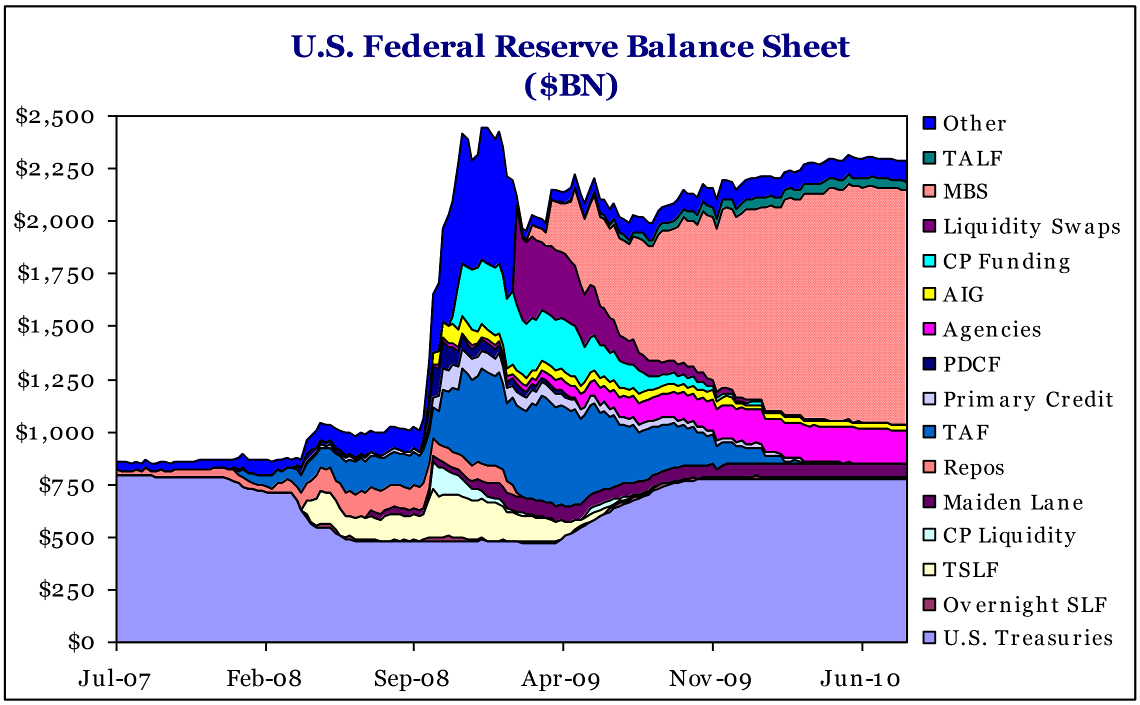
While in aggregate this is small change given the dollar amount of maturities and principal prepayments relative to the total dollar amount of securities held by the Federal Reserve, this represents a symbolic shift in policy from a passive tightening policy of allowing the balance sheet to gradually shrink itself towards the Federal Reserve actively keeping the balance sheet at an elevated level to prevent a natural tightening policy from occurring. This action essentially puts a floor on the level of securities held on the balance sheet. ISI Group estimates how the rate of maturities and prepayments would have affected the size of the Fed's balance sheet compared to the new reinvestment policy and illustrates it in the chart below.



Source: ISI Group

The affect of this change will not be significant in and of itself, but it does give confidence to the markets that the Federal Reserve is flexible and prepared to provide additional stimulus if the economic recovery continues to weaken. It also indicates that they are not willing to allow the balance sheet to contract at this point and believes doing so could be detrimental to the economic recovery. There has been speculation from market participants concerning whether the Federal Reserve would embark on a second round of quantitative easing. While this move was not a significant new quantitative easing program, it definitely left the door open to a future round of stimulus and signaled that the FOMC was ready to act.

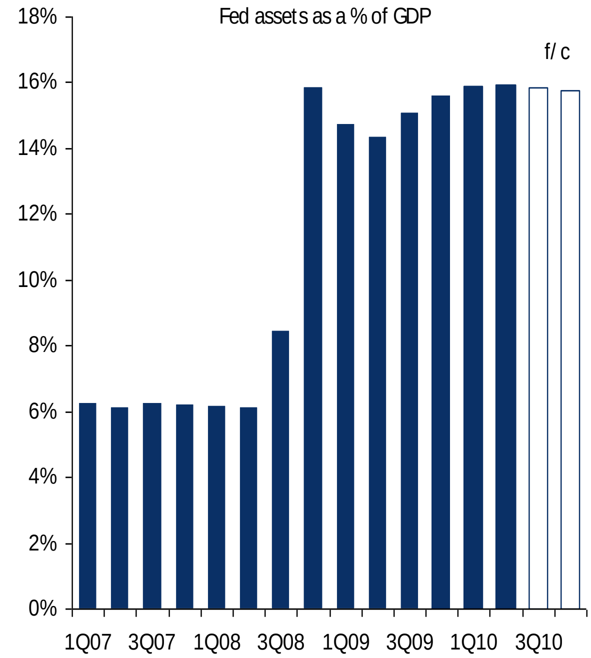
It is notable that at the June 23rd meeting and even in the more recent July 21st Monetary Report to the Congress, significant discussion revolved around how we would remove the accommodative policy that has been provided by the Fed. Most talk was directed at how quickly to shrink the balance sheet. The FOMC must have recognized a significant increase in the risk of a faltering economic recovery to seemingly shift focus in such a short time period. The chart below illustrates how the Federal Reserve's balance sheet has evolved over the past three years and how the amount of securities held has grown and is now likely to remain in the near term.



Source: Strategas Research Partners, LLC

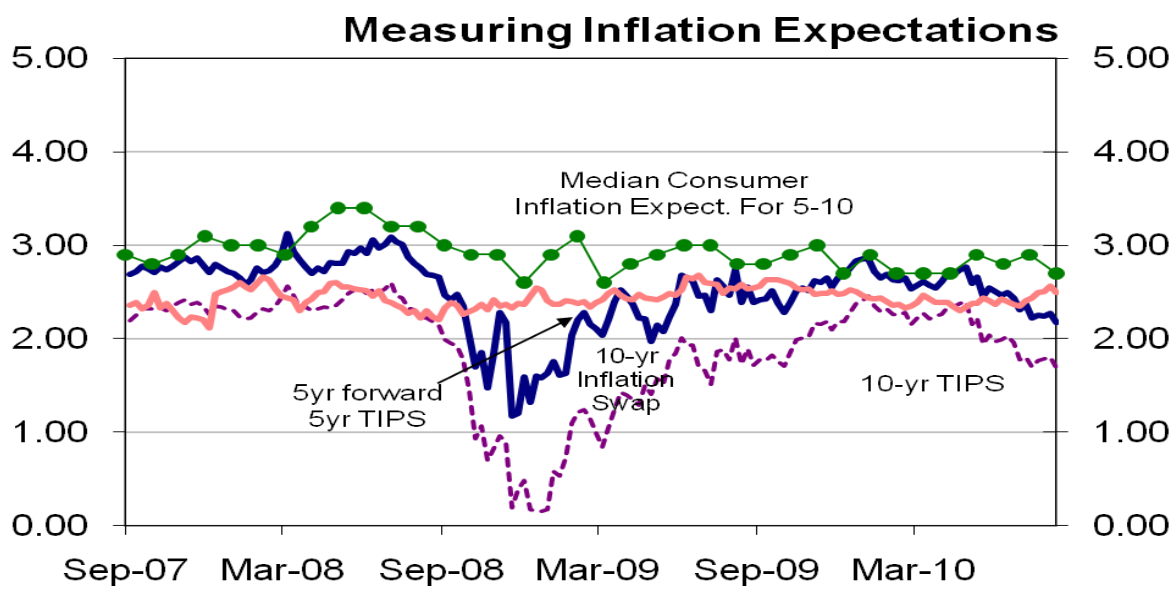
Market participants will now look to how the Federal Reserve will proceed with additional quantitative easing should the economic recovery continue to weaken. The FOMC may be unsure about how they would proceed with this as well. There has been varying opinions between committee members on whether to reinvest maturities and prepayments and whether to reinvest in Treasury securities or agency debt or agency mortgage-backed securities. There have been concerns about the Federal Reserve monetizing significant amounts of Treasury debt. There have been concerns about the affect of additional purchases on the function of agency mortgage-backed securities markets. The Federal Reserve has shifted from holding 100% Treasury securities prior to the financial crisis to having almost two-thirds of its investments in agency-related securities and the average maturity of the Treasury portfolio has nearly doubled from three and a half years to almost seven years.

There are also concerns about the appropriate level of securities held by the Federal Reserve as a percentage of GDP, which has significantly increased since the beginning of the financial crisis. The chart to the right shows the significant increase in Federal Reserve assets as a percentage of GDP since the financial crisis began. With the federal funds target rate unable to move any lower, the Federal Reserve has limited options and increasing the amount of securities held on the balance sheet is one of few tools they have available. To be effective, increasing securities purchases would have to be done in significant amounts and in ways not to disrupt the normal functioning of these markets.



Source: FRB, BEA, Haver Analytics, Barclays Capital

With the general consensus from most committee members that inflation concerns remain muted in the near term, the purchase of additional securities would likely be effective in lowering longer term interest rates. Inflation expectations have remained low and some indicators have ticked lower more recently as evidenced in the chart below.



Source: ISI Group

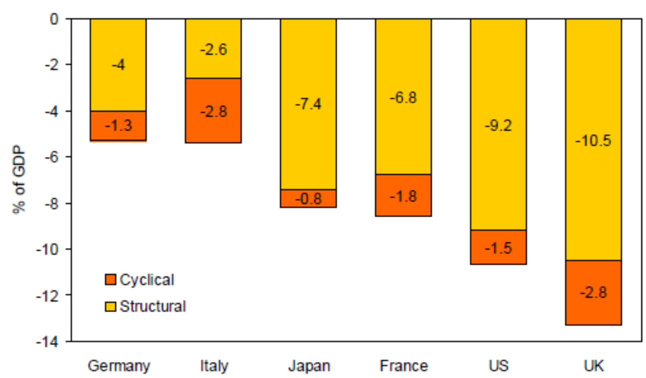
All indications are that the FOMC will look for ways to provide additional quantitative easing if we continue to see weaker economic data. Through the aggressive policy actions they have taken over the past two years, they have shown they prefer to fight this depressed economic activity on the front end and address any long term consequences of their actions down the road should they arise in the future. They have used many of the tools in their tool box already, but they seem confident they have ammunition left to address any near term weakness. When the minutes are released from the August 10th FOMC meeting, we will likely be provided with more clarity on how they will do this. If their economic outlook continues to weaken, they will likely explore additional securities purchases to keep longer-term interest rates low in an attempt to stimulate economic growth and promote price stability. They must balance this with future inflation concerns, but for now inflation continues to remain depressed and they continue to be confident in the policy tools they have if inflation concerns do arise. Several committee members appear to be much more concerned about a deflationary environment than an inflationary environment at this point. The FOMC remains cautiously optimistic that the economic recovery is proceeding, but they are clearly acknowledging that the risk to this recovery has increased over recent months and positioning themselves to provide additional stimulus should economic conditions weaken further.

Fiscal Policy

By Michael McNair

The US, as well as most other developed nations, is currently facing a fiscal crisis of unprecedented proportion. The Congressional Budget Office (CBO) estimates that the US will run a $1.3 trillion deficit in 2010. This deficit is equivalent to more than 10% of GDP and along with the 2009 deficit is the largest in the US since WWII. The most troubling aspect is that these deficits are now mostly structural in nature. The Bank of International Settlements (BIS), considered the world central bank, estimates that in the US structural deficits are equal to 9.2% of GDP while the cyclical deficit accounts for 1.5%.

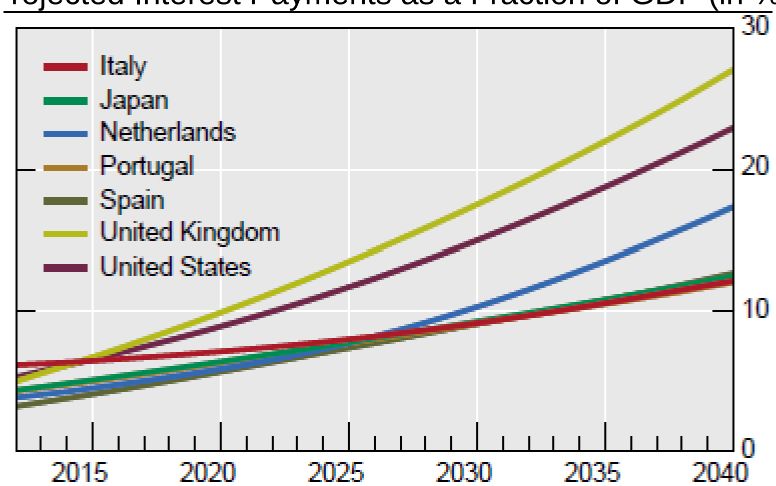
Deficits Are Structural Rather than Cyclical



Source: BIS, Independent Strategy

Last month the IMF issued a report that estimated the difference between all future expenditures and revenues, the so-called "fiscal gap". In the US the fiscal gap will annually equal 14% of GDP for the foreseeable future. The IMF estimated that the fiscal gap in Greece was an unsustainable 11.5% of GDP. The report states, "The main drivers of the fiscal gap are rising health care costs that under current law will boost mandatory spending to above 18 percent of GDP by 2050. **This means that mandatory programs will absorb all federal revenues sometime around 2050, or as early as 2026 when the cost of servicing the debt is added."**

Projected Interest Payments as a Fraction of GDP (in %)



Source: OECD, BIS

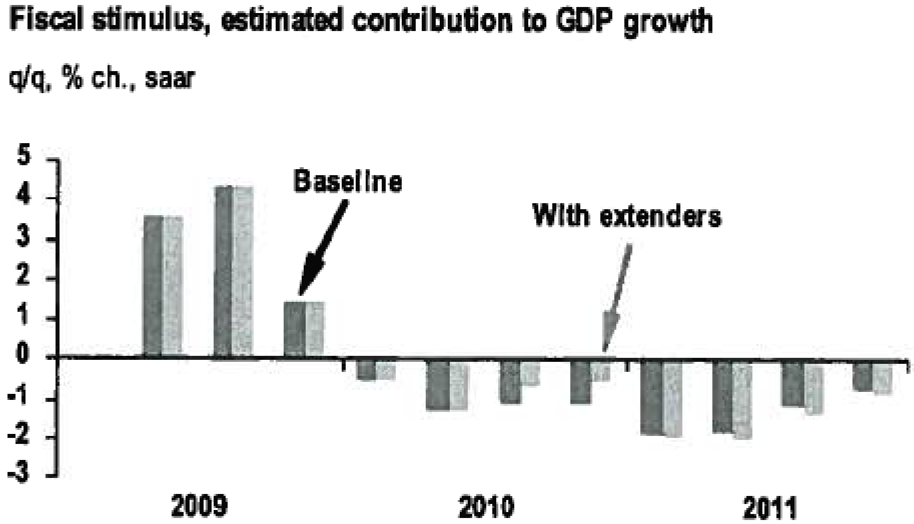
Fiscal policy was critical in helping the economy recover strongly in 2009; however, the recent string of weak data reminds us just how important the fiscal stimulus was for this growth. The end of the cash-for-appliances program in August has caused retail sales to falter since May. Looking at the chart below, it is obvious that the first time home buyer tax credit pulled forward demand and distorted the housing market over the last year.

Existing Home Sales

With the tax credit stimulus now removed, the housing market looks to be double dipping. A major concern for the housing market is that existing home sales (white line), no longer supported by the tax credit, continue to fall and make up the gap between it and new home sales (red line).

Existing and New Home Sales

Unfortunately, the winding down of the $787 billion American Recovery and Reinvestment Act (ARRA) stimulus will have even more adverse affects on the US economy. While it is estimated that there is still $330 billion of the $787 billion stimulus yet to be spent, when analyzing GDP it is the incremental change in stimulus spending that counts. Hence, stimulus spending will be a drag on growth in 2010 and 2011 because the percentage increase in spending is not as large as the previous year. The chart below shows that even with the proposed extension of some programs the stimulus will still reduce GDP by and average of 1.25% for the next two years.

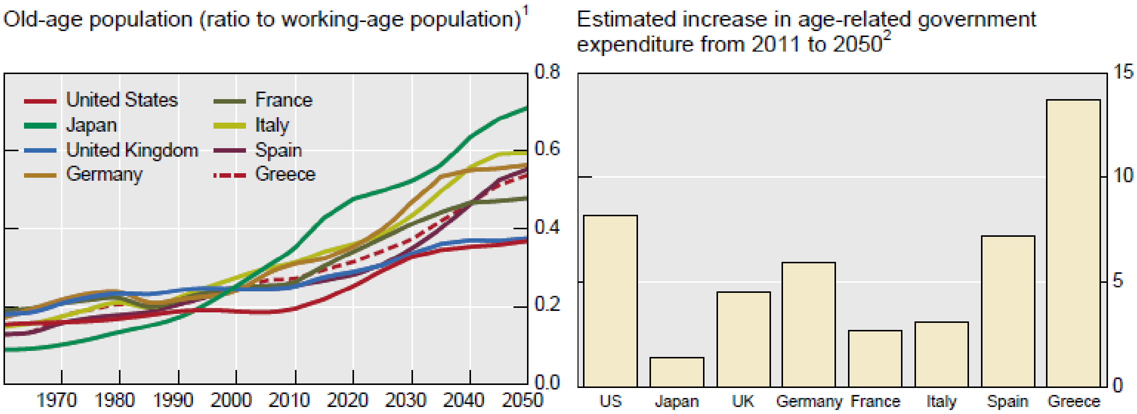


Source: J.P. Morgan

The above estimate only calculates the drag from the fiscal stimulus. The outlook becomes even more concerning when we incorporate the drag that will come from the removal of the Bush tax cuts at the end of this year. There are currently 66 provisions in the tax code that are set to increase taxes in 2011 and the CBO estimates that tax revenue will increase by 22.7% next year. It is expected that law makers will extend some of the tax cuts but doing so could add $2.3 trillion to the federal debt by 2018, according to CBO estimates. While these tax cuts will help sustain growth in the short run, it will exacerbate the fiscal imbalance and slow growth in the future as these costs are repaid.

The most troublesome aspect of the fiscal imbalance is that the current expansionary policy is occurring as the largely unfunded age-related spending (pension and health care costs) is set to explode with our aging population. Any analysis of the government fiscal position that only looks at current debt ratios and does not include the affects of these unfunded future age related expenses is incomplete and misleading. In a recent report by the Bank of International Settlements (BIS) they detail the projections of our aging population as well as the estimated increase in age-related government spending. While many economists point to Japan's aging population as the cause of their two lost decades, the chart on the bottom left shows that for the foreseeable future the US will have a much older population than Japan had during their lost decades of the 90's - '00 .

Projected population structure and age-related spending

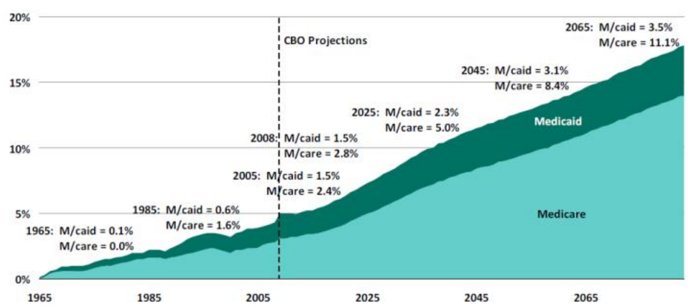


[1] Working-age population is between 15 and 64 years of age. [2] In percentage points of GDP.

Sources: IMF, World Economic Outlook, April 2007; UN Secretariat; European Commission; Congressional Budget Office; authors' calculations.

The ISI Group reiterates the projections for an explosion in age-related spending with their projection of federal spending for Medicare and Medicaid.

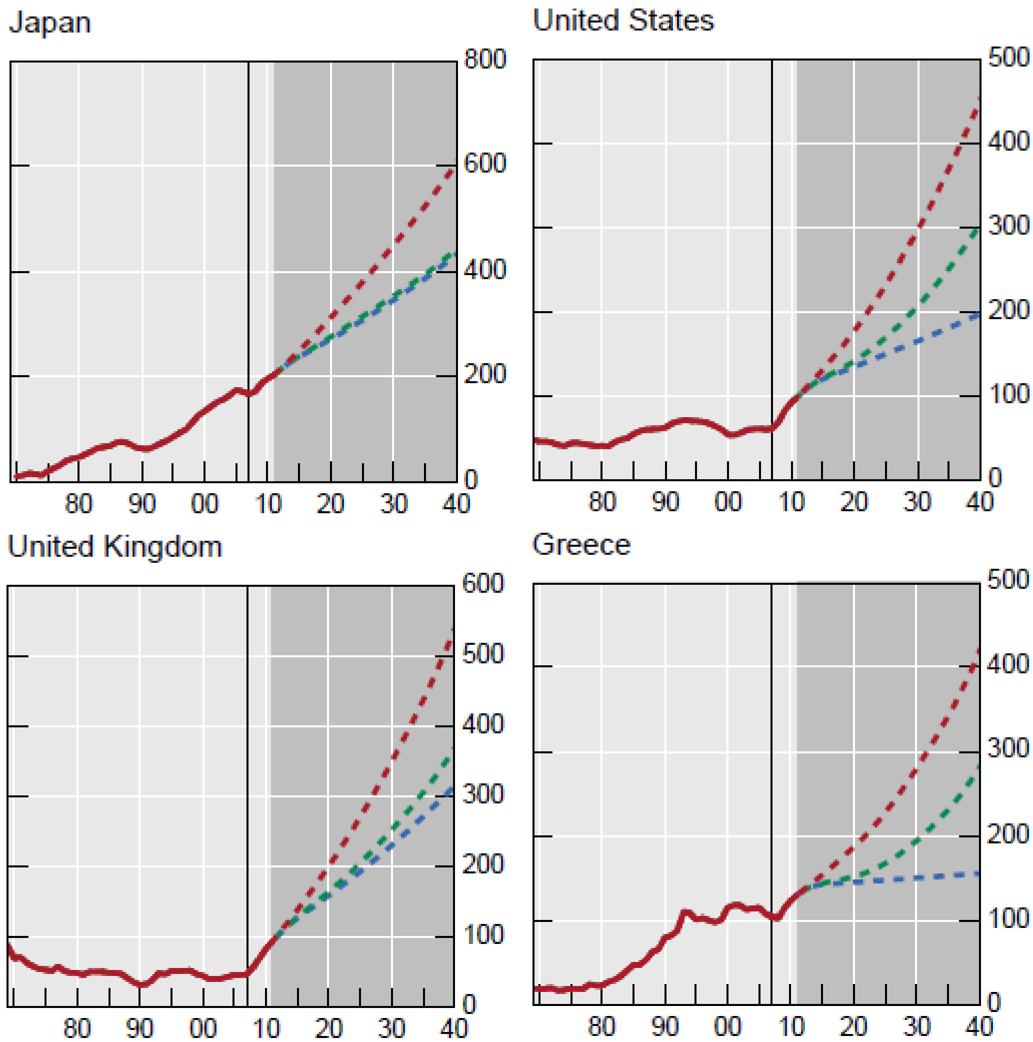
Federal Spending on Medicare and Medicaid as Share of GDP



Source: ISI Group.

Also in the BIS report, they estimate the trajectory of several developed nations government debt as a percent of GDP. In the report they show projected government debt/GDP over a 30 year time horizon in order to capture the effects of the large unfunded liabilities resulting from future age-related expenditures. The **red line** represents their **baseline** and assumes that government total revenue and non-age-related spending remain at their current levels as a percent of GDP. The green line represents gradual spending cuts and tax increases similar to some of the more harsh policies currently being proposed. The blue line represents the politically unfeasible assumption of keeping all age-related spending at current levels for the next 30 years.

Government Debt as a % of GDP (x-axis = year, y-axis = % of GDP)



Source: BIS

As you can see, even under the assumption of harsh austerity measures debt ratios in these countries will rapidly grow to unsustainable levels over the next several decades.

The State Fiscal Crisis

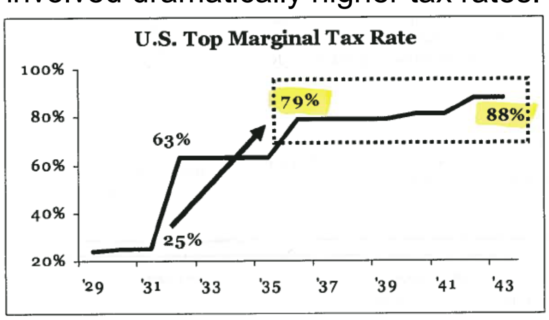
The Federal Government is not alone in facing an imminent fiscal crisis. States budgets have been hit hard over the last couple of years as sales tax and income tax revenue have plummeted. Meanwhile, property tax revenue held up reasonably well last year but reappraisals for the drop in the value of homes and commercial real estate are now ensuring that states will be hit hard from lost property tax revenue and this revenue will not snap back quickly. While revenue is dropping, expenses such as Medicaid and other benefits tied to unemployment are rising. In 2009 Medicaid spending rose by 6.6% and accounted for 21% of state general fun expenditures. In 2010 Medicaid spending is projected to increase by 10.5%. Aid to state governments helped states balance their budget last year but this stimulus is winding down. Even the newly announced $26 billion aid to state governments pales in comparison to the estimated $350 billion budget deficits states are looking at over the next two years. However, Oregon is the latest example that even these projections might be overly optimistic. On August 17th, Gov. Ted Kulongoski advised state leaders that he now expects the state's shortfall to be nearly 100% larger than the $577 million hole projected just three months earlier. In Arizona, the 15% budget shortfall is even greater than Greece's 13% deficit. Arizona Governor Jan Brewer recently stated in an open letter to her constituents that, "we face a state fiscal crisis of unparalleled dimension – one that is going to sweep over every single person in this state as well as every business and every family."

While states are required to run balanced budgets, there are numerous ways for states to circumvent these rules. State and local governments currently have $2.7 trillion of debt, which is equivalent to 200% of annual tax receipts. In addition to a massive debt load, states also face an impending pension crisis. In a recent speech Fed Chairman Ben Bernanke said that state's unfunded pension liabilities are estimated to be between $2-3 trillion and that, "states on average will have to double their typical pension contribution over the next decade to avoid collectively exhausting their pension funds during the next couple of decades." Bernanke said that states also have a collective $600 Billion unfunded liability related to retiree health benefits.

Conclusion

US budgetary policy is faced with the decision to continue excessive fiscal spending in order to prevent the economy from falling into another recession or take the steps necessary to pull the country back from an impending fiscal crisis that would hamper economic growth in the future. Our guess is that we continue to ignore resolving our problems in the present and in the name of Keynesian Economics we "kick the can down the road" and leave a declining future population to be burdened with paying for our routine current expenditures and their accompanying massive debt and interest payments. Add this to the unnecessary maintenance costs future tax payers will be forced to endure because of our neglect and lack of investment in infrastructure and it is easy to see a future generation overwhelmed by our fiscal irresponsibility.

The adjustment needed to reverse our imbalances will be extremely painful and will certainly entail a combination of much higher taxes, fewer promises and lower spending. Analysis by Strategas Research Partners shows that the precedent in this country for overcoming an impending fiscal crisis caused by the large fiscal stimulus of the 1930's involved dramatically higher tax rates.



Fortunately, history has shown us that we are capable of overcoming this problem. The taxes may have been extremely painful and even helped contribute to another dip in the late 1930's but this fiscal austerity paved the way for the beginning of the greatest economic story of the 20th century.

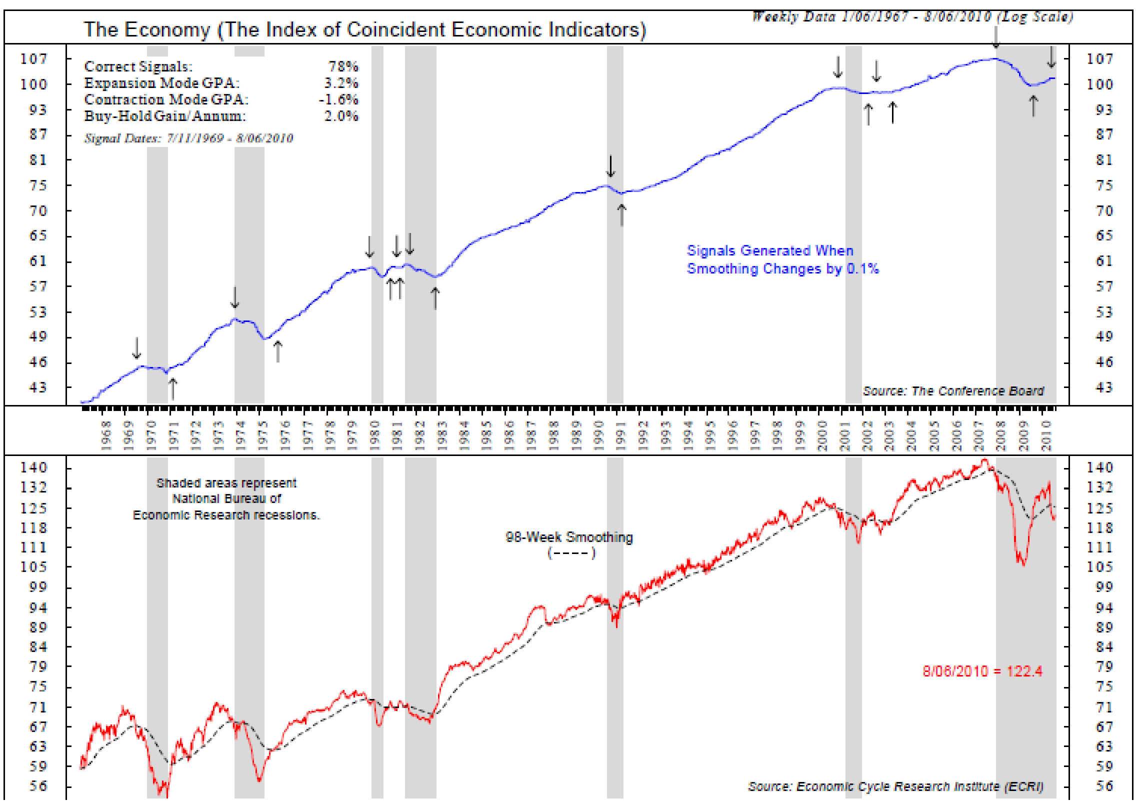
Economic Outlook

By Kevin Gamble

The outlook for the U.S. economy is “unusually uncertain” according to Federal Reserve chairman Ben Bernanke. This is certainly a characterization that is hard to argue with and one that was recently echoed by Cisco CEO John Chambers in his address to investors on the company’s latest earnings conference call. There are many cross currents currently at play in our economy leading to this uncertainty including a rapidly evolving political landscape with mid-term elections right around the corner, the possibility of a dramatic shift in tax structure which may or may not take effect in the coming year, stubbornly high commodity costs in the face of continued weak labor and housing markets, an active Federal Reserve and Congress, and a volatile investing environment to name a few.

What has become increasingly clear is that the economy has slowed down in recent months. This slowing is perhaps best revealed in the recent retraction of the ECRI U.S. Weekly Leading Index.

Chart 1: ECRI U.S. Weekly Leading Index



Source: Ned Davis Research

A few other examples of the slowdown in economic activity as we have progressed through Q2 and into Q3:

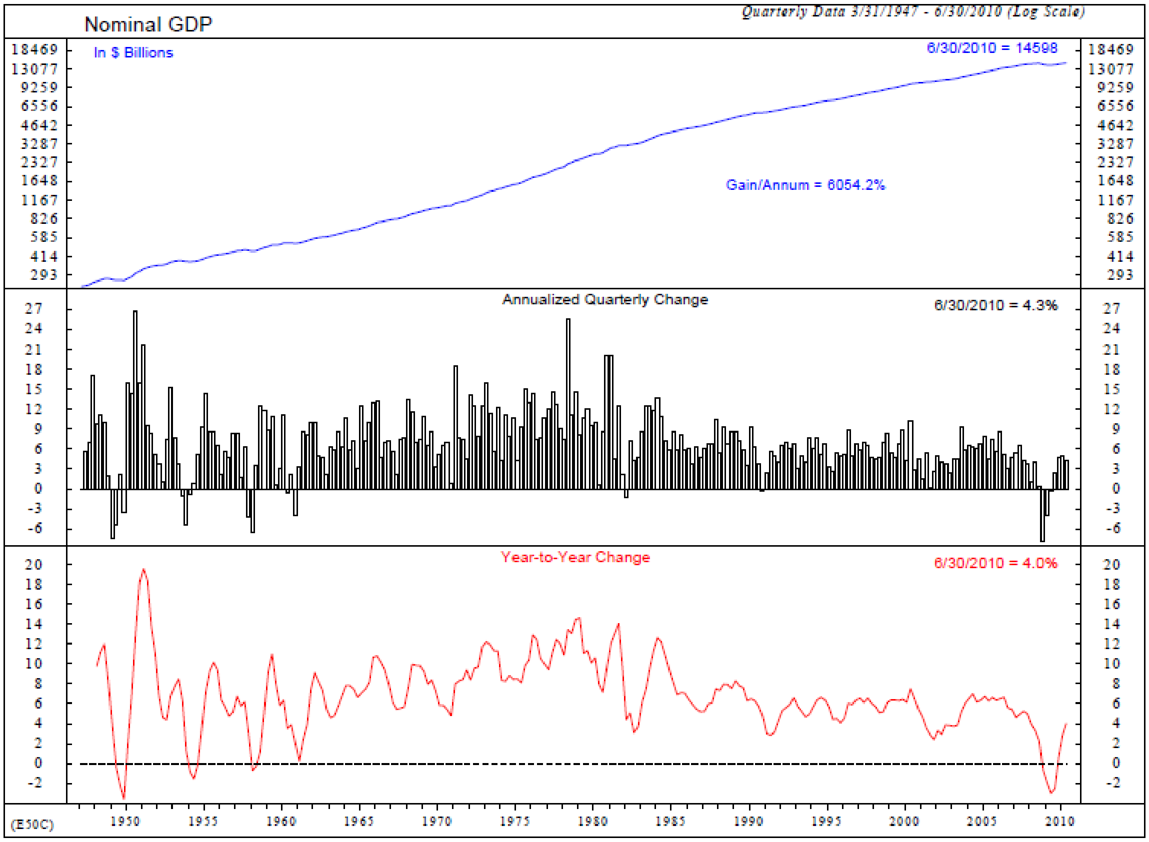
- ISM was 60.4 in April went down to 56.2 in June and began the third quarter at 55.5
- Philly Fed was 31.9 in April, fell to 19.6 in June and down to 5.1 to start Q3
- NY Empire index was 20.2 in April, declined to 8.0 in June and dropped to 5.1 in July to start Q3
- NAHB was 19 in April, fell to 16 by June and was down to 14 as Q3 began
- Consumer confidence was 57.7 to start Q2 and closed the quarter at 52.9
- The NFIB also started Q2 at 90.6 and finished at 89

Source: David Rosenberg, Chief Economist & Strategist for Gluskin Sheff

The slowdown in economic data is forcing economists to grapple with the question: Are we headed into a double-dip recession? While double-dip recessions have historically been rare occurrences (the last double-dip recession we experienced was in the early 1980s and many argue this was an intentional double-dip designed to stop the inflationary pressures), we are in unusual times and can't rule it out at this point.

According to David Rosenberg, the minus 10.5 reading in the ECRI for the week of July 16th marks a level which we have never reached without there being a recession soon to follow. Rosenberg's in-house model shows increased odds of a double-dip at 67%, up from 45% in June and 0% at the turn of the year. While Rosenberg sees the likelihood of a double-dip recession as high and rising, others such as Alan Greenspan see a slowdown within a soft recovery which will feel like a recession, but not technically dip into recession territory (a mid-cycle slowdown if you will). As always, time will tell, but what we can accurately say at this point is that economic activity is slowing.

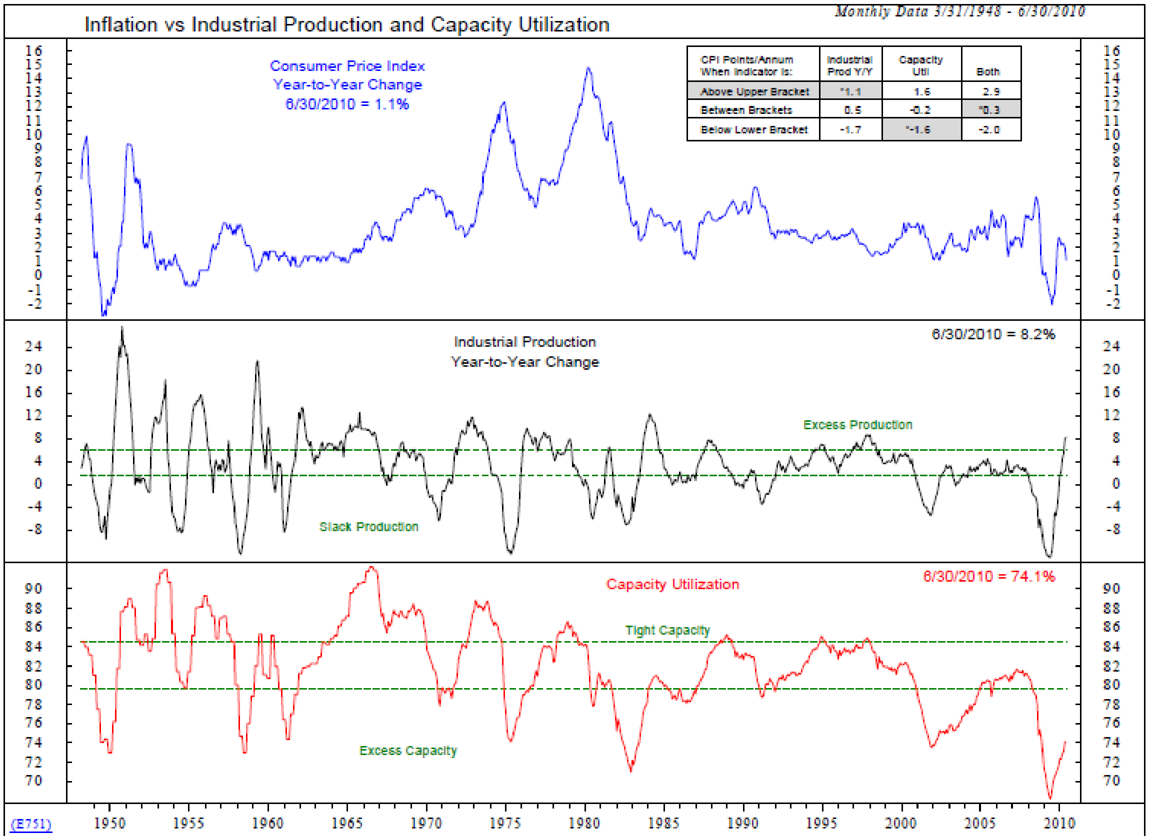
Chart 2: Nominal GDP



Source: Ned Davis Research

In stark contrast to the early 1980s, one of the unusual aspects of the current economic environment is the risk of deflation. Deflation is something the Japanese have been confronting for multiple decades now, but something we have not witnessed in the United States in over a generation. In the post WWII era, the U.S. has effectively managed to avoid broader deflationary pressures through aggressive fiscal and monetary policy actions any time we have faced a slowdown. Do we still have the same ability to contain deflation? Perhaps, but it will likely not be as easy this time and will require non-traditional measures. Another question we must consider: Should we even try to contain deflation or is deflation necessary to bring price levels back in line with incomes in this country? These are tough questions.

Chart 3: CPI and Capacity Utilization



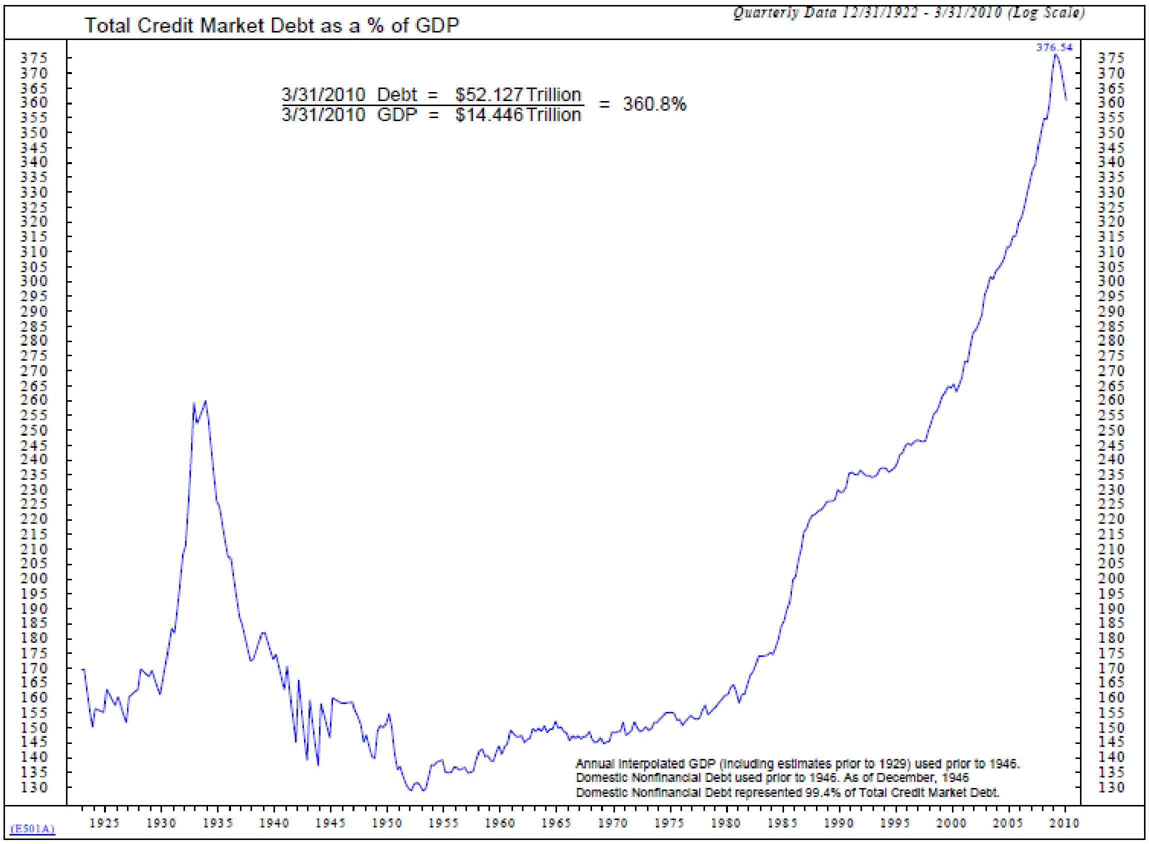
Source: Ned Davis Research

Why might this time be different? On the monetary front, we have taken short-term interest rates all the way down to close to 0% leaving us little room for traditional monetary stimulus. On the fiscal front, the marginal benefit of a new dollar of debt has been falling steadily and is approaching zero at the very same time we find ourselves with historically high levels of credit market debt relative to economic output as measured by GDP. Some economists refer to this as the Keynesian endpoint. We have obviously hit a traditional monetary endpoint as well at 0%.

In many ways this leaves the U.S. economy in a checkmate type situation as we struggle to figure out which non-traditional move to make and whether we want to take on the rook or the knight in our quest to get out of our precarious situation. There are those who argue the government has to be the answer in the absence of enough private demand and the government should do much more in an effort to stimulate the economy. Others argue the government is part of the problem and instead we need smaller government, a smarter tax code, and privatization of services to solve our growing deficit problems as a nation. Unfortunately, the lesson to likely be learned before it is all over is for us to seek to avoid the current situation in the first place as there is no easy way out. The way out will undoubtedly require tough choices as well as innovative policy actions.

What is at the heart of our economic problems? We simply have too much debt relative to our level of output. This is the case for the government as well as for the U.S. household. We have discussed the total credit market debt as a % of GDP chart on many occasions and it continues to be every bit as relevant today as when we first discussed it.

Chart 4: Total Credit Market Debt as a % of GDP



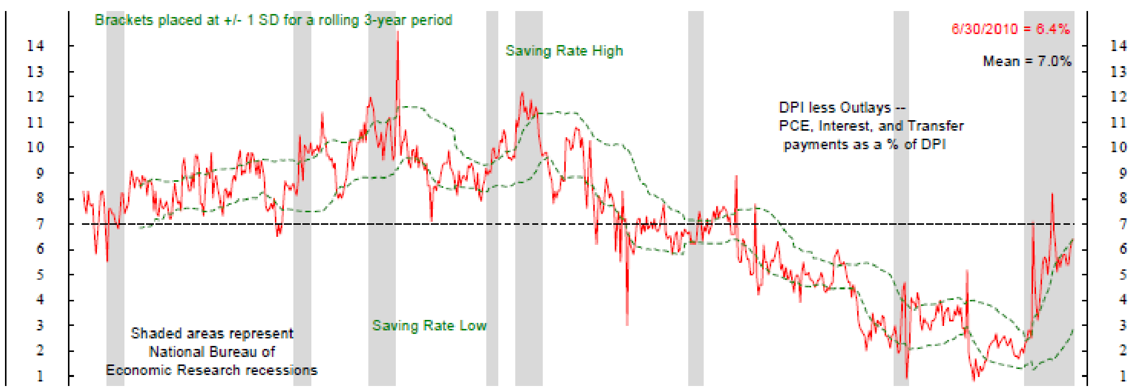
Source: Ned Davis Research

The current ratio of total credit market debt as a % of GDP stands at roughly twice the long-run average of 1.89x. In order to get back to health, this ratio must come down. Mathematically, the ideal way to accomplish this goal is for the numerator to contract (debt) while the denominator grows (GDP). At the very least, the denominator must grow faster than the numerator! This will be challenging to say the least, but is not impossible. It will require an innovative, dynamic economy which America has shown the ability to create over its history.

Great bull markets in the United States have been driven through innovation. Yes, leverage helped contribute to the bull market in the United States from 1982 to 2000, but technological innovation was very much at the heart of it as well. IBM introduced the personal computer this very month 29 years ago. The Internet in the 1990s built on the success of the personal computer. These innovations improved productivity, created jobs, and drove GDP growth. They also served to “flatten the world” so to speak and open up the global economy. It will be vitally important to our economy going forward that we continue to innovate and continue to seek ways to capitalize on the rise of globalization and the potential of the global consumer. The potential growth in emerging economies around the world will undoubtedly be important to the growth of the exports component of our GDP which will need to play a greater and greater role going forward in our growth as a nation.

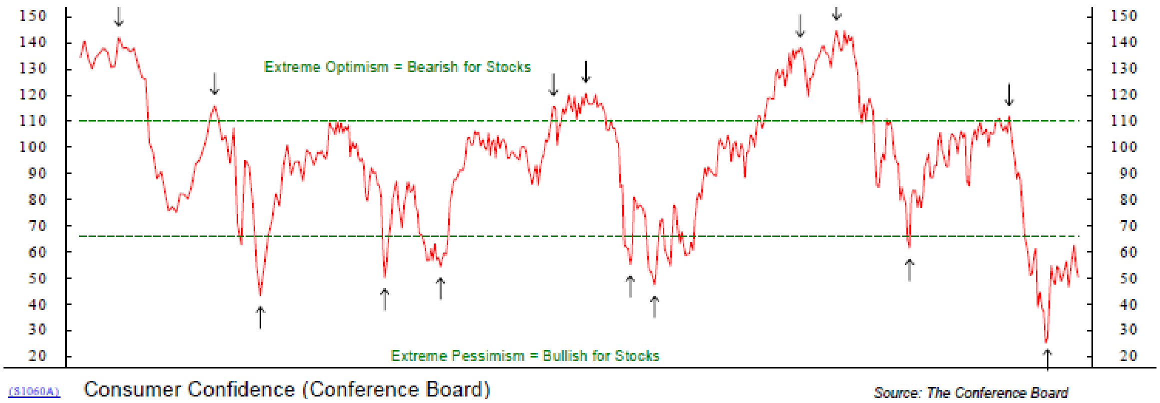
While growing export markets will be vital over time, the largest component of our current GDP (approximately 70%) continues to be dominated by domestic consumer spending. Thus, an assessment of the U.S. consumer is paramount to any economic forecast. One doesn't have to be an economist to figure out that this component of GDP is under pressure given $75+/barrel oil, an uncertain housing market, a weak labor market with 9.5% unemployment, flat wages, and the need to rebuild savings after a steadily falling savings rate since the early 1980s. The good news is the U.S. consumer has started to save again which is absolutely necessary; the bad news is the consumer is rebuilding his/her balance sheet right at the time we need spending (paradox of thrift). Once again, this is a balancing act we will be dealing with for quite some time.

Chart 5: US Consumer Savings Rate



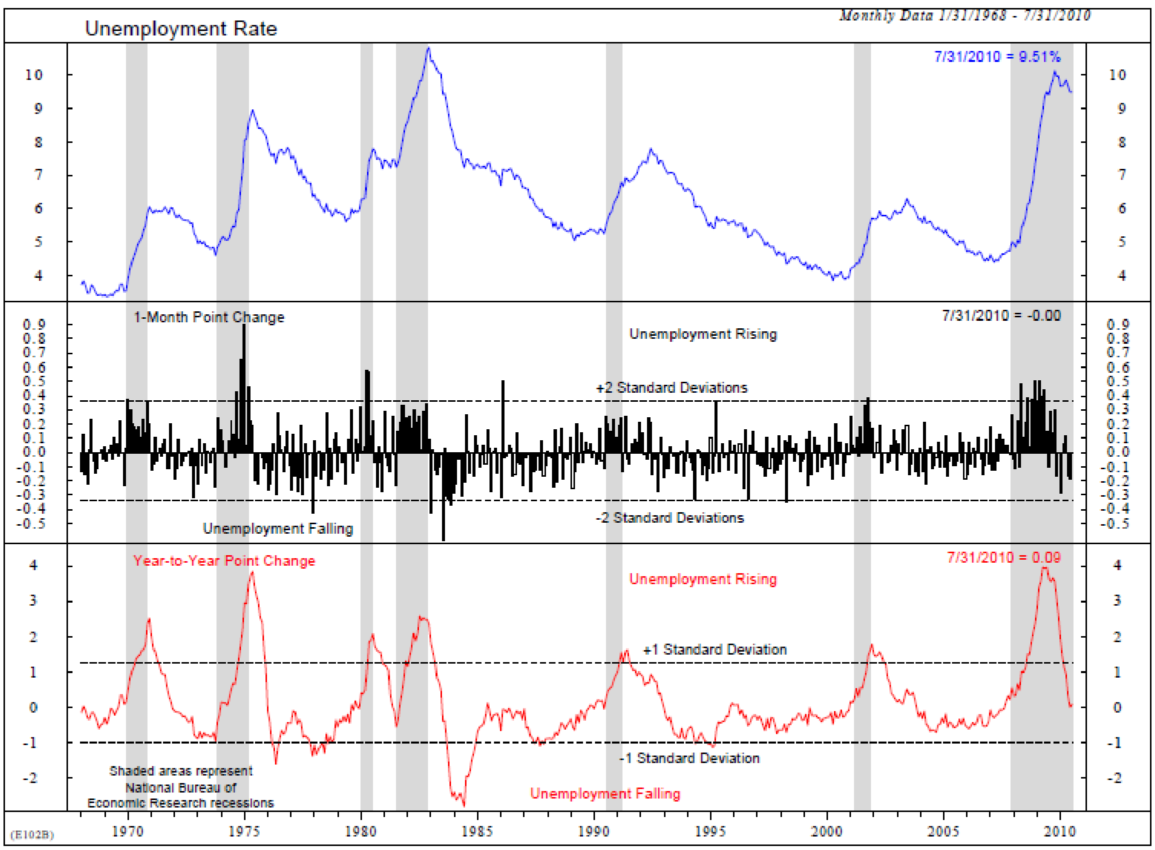
Source: Ned Davis Research

Chart 6: US Consumer Confidence



Source: Ned Davis Research

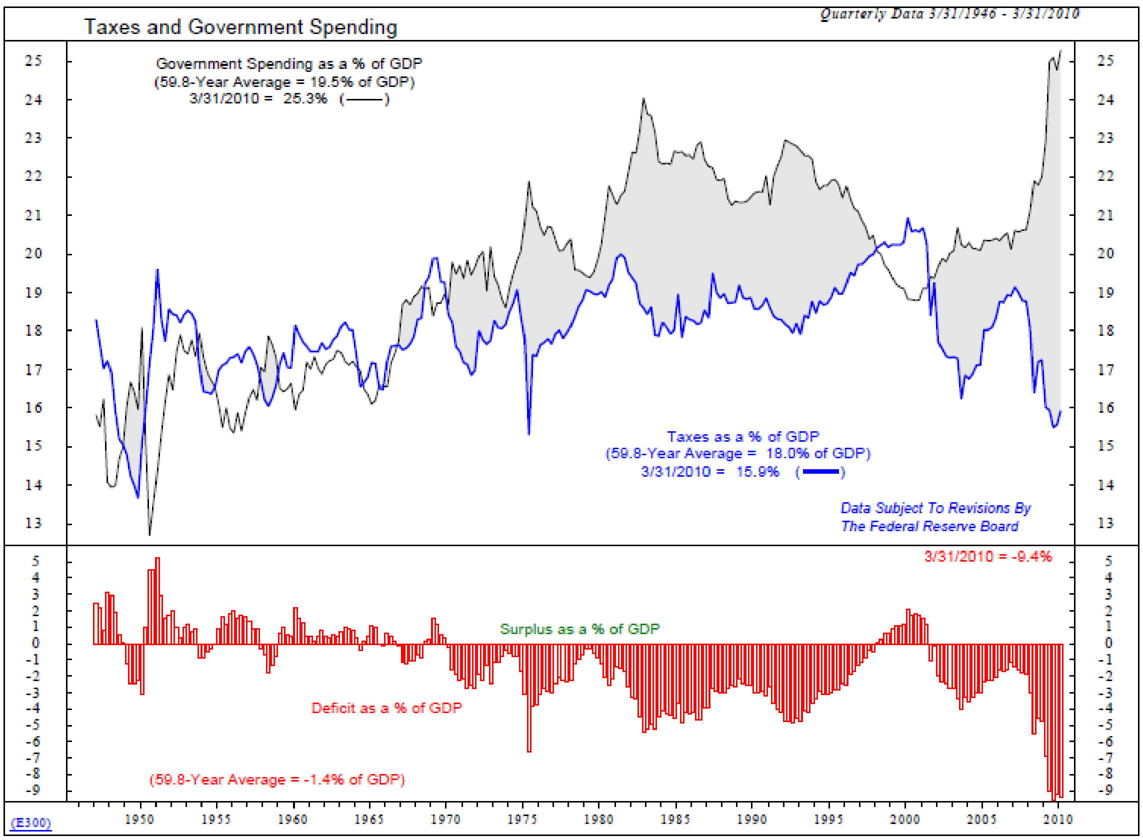
Chart 7: US Unemployment Rate



Source: Ned Davis Research

The government spending component of GDP continues to be very relevant to the economic outlook as well. While government spending from the economic stimulus package has been supportive of GDP growth in the short-run, the positive effects will slow as we progress through the end of the year and into 2011. In addition, President Obama has formed a commission to look at ways to cut the $1 trillion + federal deficit we are currently running which will undoubtedly require cuts and some tough choices. Thus while government spending has positively affected GDP in 2010, the jolt is diminishing as we move into next year in the absence of a new spending initiative. It is important to keep in mind that the increased government spending is coming from borrowed money which is increasing the numerator of the total credit market as a % of GDP chart. In order to improve the ratio of our level of debt to output, it is incumbent upon the increased debt load to earn a positive internal rate of return.

Chart 8: Taxes and Government Spending as a % of GDP



Source: Ned Davis Research

In summary, the growth in the economy following the sharp rebound off the lows of early 2009 has undoubtedly begun to moderate. Perhaps Bernanke said it best in coining the outlook from this point forward as "unusually uncertain." While there are always unknowns and uncertainties in economic forecasting, there are more variables than ever at this point in time. Taxes are a good example. Without any changes between now and year end, the top marginal tax rate goes from 35% to 41%; capital gains goes from 15% to 20%; the top dividend rate rises from 15% to 39.6%; and estate taxes from 0% to 55%. Obviously, if left unchanged, these increased rates will be significant. We expect changes, but what the final structure looks like or whether we simply postpone the decision for a year is anyone's guess.

We are hopeful for the best as we move through the home stretch of 2010 and into 2011, but we do acknowledge the risk of a double-dip recession is unfortunately present and growing. Confidence in the recovery will remain vitally important. What the economy does have going for it is the fact that non-financial corporate balance sheets are very healthy. Cash on the balance sheets of non-financial companies is in excess of $1 trillion. The best stimulus for the economy would come from the deployment of this idle cash into positive internal rate of return projects as this would stimulate economic growth without adding to government or household debt. In many ways, the confidence of corporate America to deploy this cash holds the key from this point forward.

Interest Rates and Fixed Income Strategy

By Nick Prilliman

At our last meeting in May, we discussed the overall improvement in the credit markets from the prior year even as problems in Europe tried to derail the gains. The fixed income bull market entered its 29th year with falling rates and tighter spreads. Most debt products performed well over the last three months as investors fled western equity markets in an effort to reduce risk in this current age of high volatility.

In June, macroeconomic announcements were largely viewed negatively with a few areas showing relative gains. New-home sales rose 23.6 percent to 330,000 units. While the improvement sounds impressive, it was the second slowest June sales pace since 1963. The National Association of Homebuilders indicated sluggishness in the sector as builder confidence fell from 22 to 17 as the expiration of the Homebuyers Tax Credit expired two months earlier. On the employment front, the economy improved slightly, but at a pace that was far below trend at the current stage of a typical recovery. For the month, the ADP National Employment Report showed total employment increasing by 13,000. Also, the Philadelphia Fed survey plunged from 21.4 to 8.0. These fundamental signals as well as concerns over European sovereign credit risks contributed to strong declines in yields among most aspects of the US Treasury curve. The steepness of the yield curve flattened for the month as May CPI data rose by a mere .1 percent which allowed long-dated Treasuries to outperform. The Fed remained on hold at their June meeting and stated that the federal funds rate would stay low for an extended period.

In the agency debt sector, the spread advance accelerated in the front end of the curve as the 2-year lead the way. Supply was muted for the month, while demand was exceptionally robust from investors like central banks who took down some 30 to 40 percent of various deals in June, according to JP Morgan. Longer dated agencies were range bound as flight to quality flows had a larger concentration in the shorter maturities. In mortgages, the scene was different than agencies as the mortgage sector received heavy fixed income inflows due to a confluence of factors which caused spreads to tighten. One of the main reasons was lower refinance activity due to tougher loan standards. This caused the convexity profile to become less negative, so investors were more willing to purchase mortgages in a falling rate environment. Also, mortgage origination was low for the month which reduced the supply coming to the market.

The corporate sector had a sub-par showing in June as the US high grade credit index posted .19% of negative excess returns for the month, according to CreditSights. The negative excess returns were generated across various sub-sectors from financials to utilities with industrials experiencing the greatest weakness. While these were poor results, they were an improvement over May when the European sovereign crisis and the BP oil spill caused significant spread widening for many corporate issuers. High yield was also slightly negative for the month as sub-sectors like technology and transportation ex air/rails underperformed.

The month of July saw an improvement in risk taking among equity markets, sovereign debt markets, and corporate debt markets as European bank stress tests proved to be better than expected. The rally in risk was also bolstered by strong corporate earnings in the latter half of the month. On the economic data front, the news did not support the positive movements in the markets. ISM manufacturing printed at 55.5% in July which was a percent lower than June. The University of Michigan index of consumer sentiment fell 9.5 points, the largest monthly decline since October 2008. Initial jobless claims also rose over the course of the month which showed a persistent weakness in the labor market. With adverse changes in data being offset by the improved perception of risk, the Treasury market was range-bound in the terms of prices. The curve steepened as the long end sold off with the reduction in flight to quality purchases.

The agency debt space experienced a large bull flattener as investors reached for yield in longer dated paper. Two-year agencies slowly ground tighter while the 7 and 10-year areas saw yields fall by over 10bps. This is in accordance with the movements along the Treasury curve. Technicals and the lack of issuance were the primary drivers of the move as valuations were by no means attractive. In the terms of callable agencies, high investor demand for additional yield drove performance even though redemptions were the highest in over a year.

Mortgage dollar prices set a record high in July as Treasury yields and mortgage spreads all declined. The spread fell to 53 bps over the 10-year Treasury as money managers and banks tried to compensate for their large underweight by chasing higher prices. Supply remained muted as fewer refinances were entering the pipeline and Americans continued to be absent from the housing market.

With robust investor sentiment coming back into the market as fears of a European financial crisis dissipated, US credit markets surged higher with the high grade index posting a 1.35 percent excess return for the month of July. Financials led the move with an excess return of 1.6 percent for the month. Among sub-sectors, energy was the top performer with a 2.5 percent excess return as the BP oil leak was halted in late July. Across the ratings spectrum, the lower rated indices tightened more than higher ones as risk aversion waned. In the high yield space, an excess return of 2.41 percent was generated with insurance companies leading the charge with a 6.5 percent excess return after a horrific two month stretch. Among corporate credit curves, most saw a flattening as investors reached for yield on the longer dated parts of the curve. In terms of issuance, CreditSights said the high yield primary market reopened after the June turmoil and a total of $22 billion of deals were brought to the market.

August started off on a positive note with most corporations posting better than expected earnings. As the month continued, economic data exhibited further weakness and caused many market prognosticators to wonder about a double dip recession. According to JP Morgan, personal income, pending home sales, and vehicle sales were all lower than expected. Initial jobless claims were rising again as well. In the Treasury market, 10 year bond yields have already put in an impressive

month with yields declining over 30 bps. The long end of the curve is continuing to flatten in the wake of low inflation, weak economic data, and weak equity returns.
While Treasuries were off to the races, agency debt and mortgages have had a hard time outperforming on a spread basis. While they have remained somewhat stable, investors became more focused on riding the trend of declining rates using Treasuries rather than their less liquid brethren. The idea of falling rates was further solidified when the Fed kept their low rate language in their monthly statement and implied that they would again be on hold for an "extended period". On the mortgage side, the spread began to leak wider as rumors surrounding a government-induced refinance wave began to enter the market and worrisome investors began to lighten their positions. Higher coupon pools have suffered the most as investors looked to protect themselves from refinancing activity at high dollar prices. Another reason for the spread widening in this space was the announcement by the Fed that they would reinvest their mortgage paydowns into Treasuries. These events have caused mortgages to underperform in the first half of August.

Corporate credit indices continued to grind tighter though mid-August with the Barclays aggregate index posting a .29 percent excess return over Treasuries. Utilities have been the leader as their long duration took advantage of the significant Treasury bull flattener. Industrials also posted better returns than the rest of the corporate space while financials lagged the group. High yield indices have been flat to negative for the month as investors exhibit greater levels of risk aversion in the wake of a mild equity correction. Bond issuance in high yield has been vigorous in August. According to the Wall Street Journal, A record $15.4 billion in junk bonds were sold in the second week of August. For the entire year, the volume has already surpassed $155 billion which is very close to the previous record of $163.6 billion sold in 2009. Investor appetite for incremental yield has been the main driving force behind the demand.

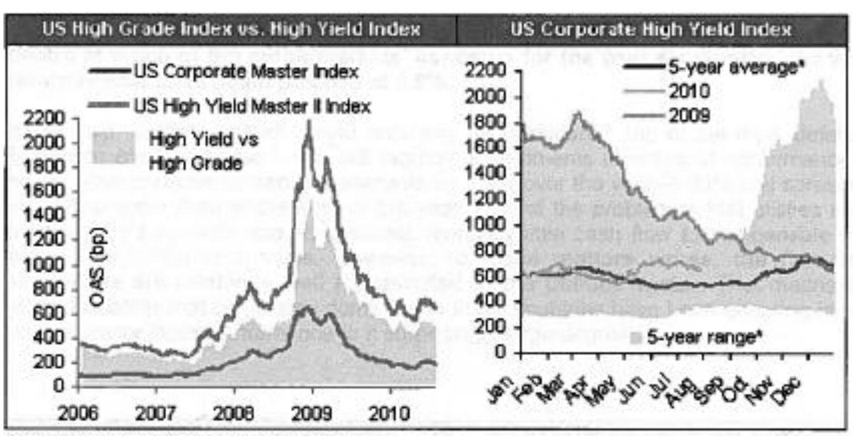
The outlook for the next year is cloudy as potentially weak economic growth could be offset with government stimulus. In fixed income, it seems that the Federal Reserve will keep the fed funds target rate in the zero to .25 percent range as GDP and inflation come in below trend. This means the front end of the Treasury curve should be anchored until something fundamentally changes. Treasury issuance should be heavy over the coming year as the Federal Government continues to run persistent deficits in good and bad economic environments. While this is a negative for the market, the Fed has recently announced they will be reinvesting mortgage paydowns into Treasuries which should provide a backstop bid for those securities. Overall, Treasuries should perform well as the long term trend of lower rates that has been in place for 30 years continues.

The steepness of the Treasury curve appears to be changing the trend that was in place since 2007. As one can see from the chart below, the 10-year Treasury is beginning to outperform versus the 2-year. This flattening of the curve is consistent with the economic data that has been announced. With GDP running at 2.4 percent and the consumer price index for all items less food and energy at .9 percent over the last 12 months, longer dated treasuries have a better than average probability of outperforming.

Source:Bloomberg

From an agency debt and mortgage perspective, the outlook is neutral as tight spreads, high volatility, and a lack of Federal Reserve sponsorship will keep outperformance to a minimum. Supply constraints should limit the extent of the widening. Over the next year, there could be heightened event risk in these areas as the US Government tries to stimulate housing. This could come in the form of a streamlined refinance program in mortgages which could cause losses due to prepayments or a restructuring of the government guarantee for Fannie Mae and Freddie Mac. These events, or some derivation of them, could cause underperformance if they were to occur.

Besides May and June, corporate credit has continued to perform well for the year, although the pace of the advance is much slower than last year. The chart below illustrates the point. Further upside in prices is possible next year as investors continue to reach for yield in the current low rate environment and as long-dated Treasuries appreciate. In high grade corporate issues, long term bonds will be the place to be as investor roll down a very steep curve. In high yield, the better risk/reward trade is probably on the front end of the curve. With economic data remaining suspect for a vigorous recovery, long term high yield paper could prove to be troublesome in the event of a double dip or an early recession. Overall, US corporate bonds will remain well bid as investors flee volatile equities and crisis prone European sovereign debt markets.



Source: ML Indices (C0A0, H0A0), CreditSights
Source:CreditSights

From an active portfolio standpoint, the start of the summer season saw a number of Treasury curve trades. Over the last three months, we swapped out the 2-year and into 5 and 7-year paper while also swapped out of the 5-year into 10-year paper. This was completed to lengthen the duration of our Treasury holdings, so we would outperform in a bull flattener. While we are underweight in the sector, the trades allowed us to pick up incremental basis points as yields on the long end of the curve fell.

Participation in corporate new issues was limited as valuations became expensive in a number of different sectors during the quarter. Relative value trades were the norm as certain portions of the capital structure allowed the portfolio to pick up incremental yield with minute increases in credit risk. Curve trades were also employed to take advantage of better yields in longer dated paper.

In the agency space, we tried to keep our weighting and duration the same as valuations were not compelling enough to add new money. We swapped out of a number of short issues and replaced them with intermediate ones to take advantage of the steep yield curve. We also tried to pick up additional yield by purchasing callable issues. Mortgage activity for the month was one of risk reduction. In the first part, we rode the tide of higher prices as both the spread tightened and Treasuries rallied. In July, higher coupon pools began to act poorly when the rumors of a government induced refinance wave started to enter the market. In response to this market action, we undertook a number of coupon swaps from the 5.5 percent coupon to the 4.5 percent coupon. The trades should help reduce our refinancing risk as lower coupons have options that are less in the money. We also added incremental dollars to the mortgage space to offset previous prepayments.

Domestic Equity Strategy

By Allan Carr

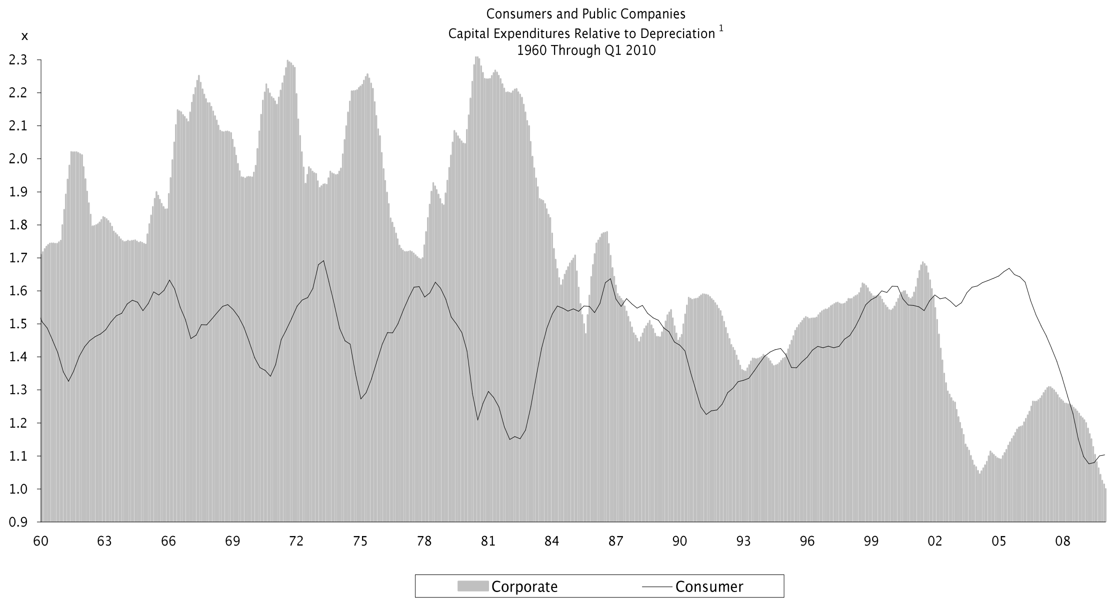
Since our last update, a lot has transpired globally yet the S&P 500 is virtually unchanged. While fears of a double dip recession are not completely gone, they have diminished. However, the momentum seen in the US economy in late April/early May has turned sluggish causing growth estimates going forward to be tempered. While there are many positives such as earnings and valuation that are keeping the market from falling, the fear of the unknowns appears to be keeping the market from moving higher.

At our last update on May 20, the market had fallen roughly 12% and the VIX (volatility index) had doubled in less than a month on the fallout in Greece and fears of a sovereign debt crisis. Over the next month we stabilized and bounced back over 4% as global credit contagion fears quieted. Then in late June economic data started to soften and worries of second quarter earnings falling short caused the market to fall 8.5% in two weeks. As we headed into earnings in the first of July, we were threatening to break through the 1000 level on the S&P 500.

But once again earnings impressed and for every one company that missed estimates there were five that beat. Earnings were up over 50% from the second quarter of 2009 and beat analyst forecasts by over 10%. Credit quality improved at banks, free cash flow remained strong even in the face of inventory rebuilding and margins continued to surprise on the upside.

The predominant reason for better than expected earnings across all sectors was margins. Firms have reigned in expenses, cut headcount, and have yet to significantly ramp up capital expenditures. This has led to very lean cost structures and thus a ton of operating leverage. Empirical Research notes that in the second quarter margins expanded “at over twice the rate that’s been typical at this stage of the recovery.” They went on to add that “margin improvement has been broad based, with around 70% of companies reporting an improvement.”

The bear case on the margin story is the pace of improvement is unsustainable. The bull case is if there is a sustained economic pickup, operating leverage will lead to robust earnings. This in turn will lead to companies needing to add employees and spend money, i.e. a capex rebound. Empirical notes that “both corporations and consumers are reinvesting at record low levels, and given where the latent operating leverage resides, any move off the bottom should provide multiplier effects and a meaningful upside to earnings.” The chart below from Empirical depicts the depressed levels of capex.



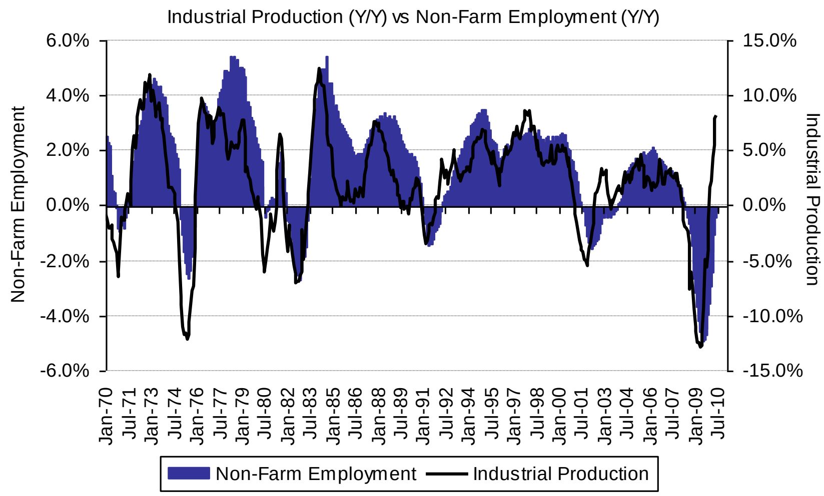
Source: Federal Reserve Board, Corporate Reports, Empirical Research Partners Analysis.
[1] Large-capitalization stocks excluding energy and industrial commodities; data smoothed on a trailing six-month basis.

On a positive note, for the first time since the fourth quarter of 2008, capex was positive sequentially in the second quarter. Hopefully this is just the beginning on the capex front.

The positive earnings seen throughout July helped stabilize the market and the S&P bounced back over 10% from July 2nd to August 9th. Then on August 10th, the FOMC decision came down which revealed several things. They described the economic recovery as "more modest" than they had previously thought. They also stated they would start purchasing treasuries with proceeds from maturing MBS (mortgage backed securities). This was a change of plans as they had been shrinking the balance sheet by allowing maturing MBS to roll off. The market reacted positively initially as the major indices shot straight up. However after digesting it the market sold off into the close and then got pummeled the following day and finished down nearly 3%. As of this writing, the S&P is still hovering around the 1100 level.

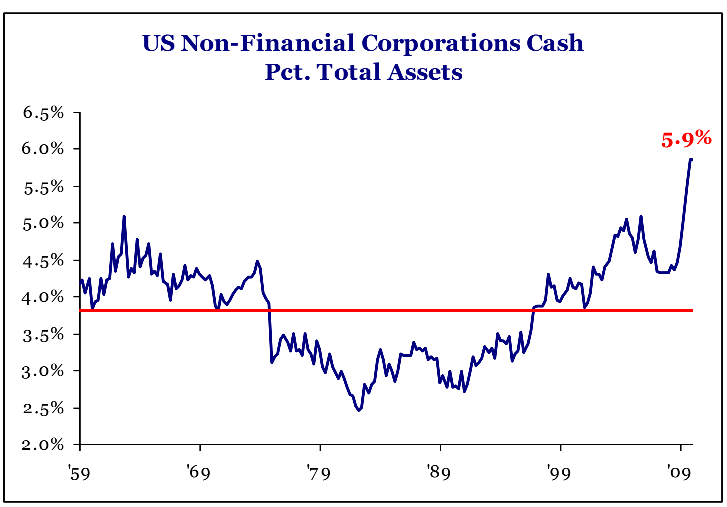
Where do we go from here? Most of the headwinds we face are well known and covered in the economic, fiscal, and monetary pieces of this update, so we will touch briefly on them. Will the economy continue to soften or will it break out of the soft patch? What will Washington do with the Bush tax cuts set to expire, and in particular capital gains and dividend taxes? What will they do to stem the budget deficit? What's in store for upcoming midterm elections? What about the global economy? What about jobs?

It goes without saying that employment growth is extremely important for the economy and markets going forward. With the momentum of the economic recovery slowing recently, we've seen a softening in employment data as well. Tobias Levkovich of Citigroup points out that employment lagged GDP growth coming out of the last two recessions so it shouldn't be surprising the same is happening this time. As pointed out in discussing margins, companies are running extremely lean and are hesitant to add workers. The chart below shows industrial production versus non-farm employment.



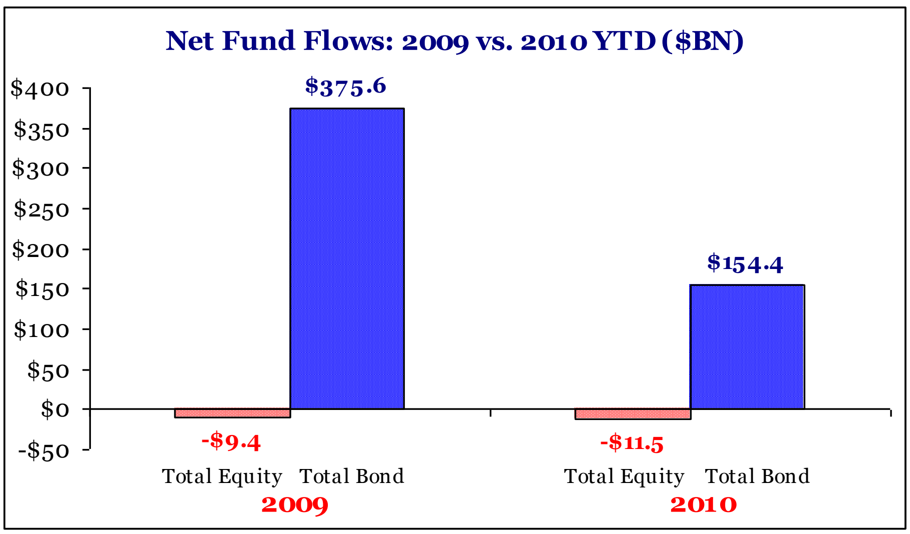
Tobias notes "production has spiked and is well beyond historical employment trends. As such, it would argue for some job growth to ensue as companies may be very efficient but they are also stretched on manpower and inevitably will have to add some workers. This may not placate an anxious nation soon enough, but the data is more supportive than many investors probably think."

While the economic and political landscapes are hard to predict, we can talk about some themes that are supportive of the equity markets. One theme we have mentioned on numerous occasions is the strength of corporate balance sheets. Each quarterly update we point out that cash reserves for corporation are at record levels and this update is no different as seen in the chart below from Strategas.



Even though earnings were strong, managements remained cautious on the second quarter conference calls. The money we see being spent is on more flexible/short term things such as debt reduction and share buybacks as CEO's are hesitant to add workers or start big capex projects. Given what we just came out of combined with all the uncertainties around the economy and Washington, it's not shocking that companies are being protective of their cash. When the picture becomes clearer there is loads of cash waiting to be put to work via M&A, hiring workers, meaningful capex spending, dividend hikes, etc., all of which would be positive for the markets.

One of the more popular contrarian views of investing is to follow money flows and see what people are piling their money into. From tech stocks in the late 90's, to real estate and commodities more recently; at some point you'll be rewarded for being on the other side of where the herd is putting their money. The chart below from Strategas shows where the money has been going lately.



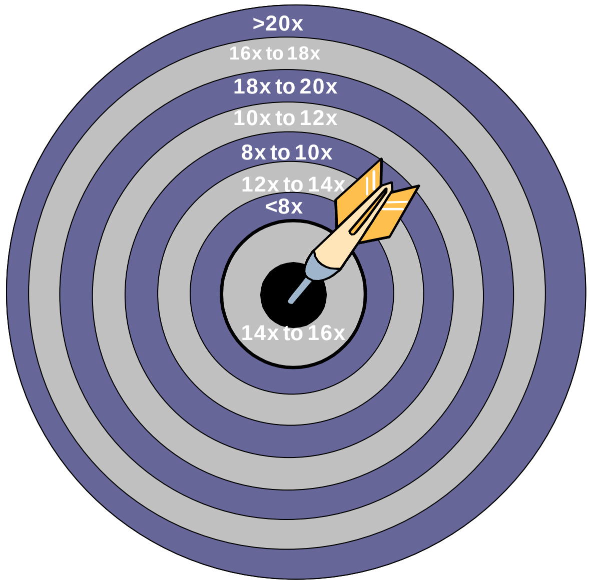
Even with the 10 year Treasury blowing right through 3% and down below 2.6% as of this writing, people continue to pile money into bond funds. With an earnings yield of roughly 7% on the S&P 500 versus a 2.6% 10 year Treasury, we feel the risk/reward is more favorable for equity markets.

Lastly and what we always need to look at in good times and bad is valuation. On a trailing 12 month basis the S&P 500 is trading at roughly 15x. While 2011 estimates are coming down, the S&P is trading at roughly 12-13x on 2011 numbers. As the chart below from Citigroup shows, the market is trading in the "sweet spot" on trailing earnings. Since 1940 has been the range that offers the most attractive 12 month returns.

The Valuation Bull's Eye

P/E Ranges & Subsequent 12 Month Returns (since 1940)

<8x:	Average	16.5%
	Median	17.5%
8x to 10x:	Average	10.9%
	Median	7.7%
10x to 12x:	Average	9.1%
	Median	7.6%
12x to 14x:	Average	7.5%
	Median	7.9%
14x to 16x:	Average	15.9%
	Median	17.9%
16x to 18x:	Average	5.3%
	Median	6.6%
18x to 20x:	Average	7.5%
	Median	7.5%
>20x:	Average	-2.4%
	Median	-8.7%



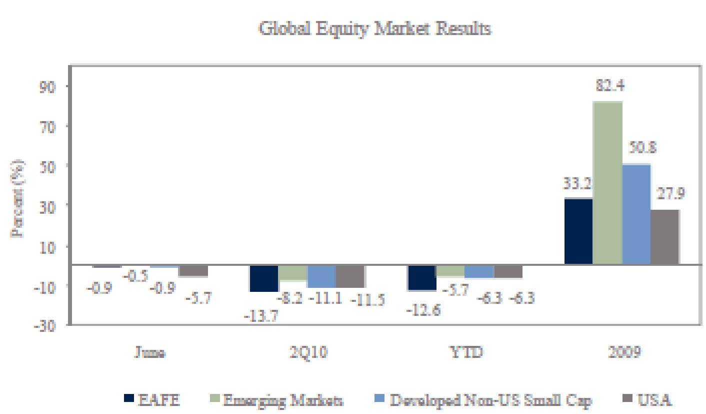
Sweet Spot (14x to 16x)

In conclusion, there are plenty of positives that in a normal environment would have investors falling over each other to buy equities. But an abundance of uncertainty is keeping investors from buying equities and in fact has seen them continue to pile into treasuries yielding 2.6%. Valuation and fundamentals suggest nice returns for long term equity holders, but the near term could continue to be a volatile ride.

International Equity Strategy

By Steve Lambdin

In the second quarter of 2010, global markets were dominated with concerns surrounding the European sovereign debt crisis, a potentially slowing U.S. recovery story, and moderating expectations of future growth in China. These issues pushed global equity markets significantly lower during the quarter. The bailout package presented by the European Central Bank (ECB) has brought to light the dire situation many countries in southern Europe are facing. As a result of this, these countries have had little choice but to initiate emergency fiscal measures such as wage reductions, increased value-added taxes, cutting public works projects, and changing retirement rules in an effort to remain solvent and reassure shaky credit markets. These measures will no doubt curtail some level of economic growth in this region over the next couple of years. To what level exactly is subject of great debate at present. In Asia, the big news in the quarter was what a slowing Chinese economy means for the rest of the world. Inevitably, China cannot keep up the double digit pace of economic growth indefinitely. Investors are trying to grasp what growth in the 7% to 8% range will mean. This adjustment has certainly made equity markets very weak around the globe. Also, one cannot forget the oil rig disaster in the Gulf of Mexico with BP. With BP being the second biggest weight in the MSCI EAFE Index, its near -50% decline during the quarter had a negative effect on returns during this timeframe. However, even after the many factors that pushed markets lower in the quarter, most economies continued to expand during the quarter. Interest rates continued to fall as central banks are doing everything possible to foster the economic rebound going forward. Manufacturing still remains a growth driver as inventory levels still look to be in decent shape. As a result, corporate earnings are still showing impressive year over year growth and should be strong for the balance of 2010. The key issue on most investors minds at this point is how strong will the global economy will be in 2011. Answers to this could no doubt steer the global equity markets in the coming months.



Source: William Blair

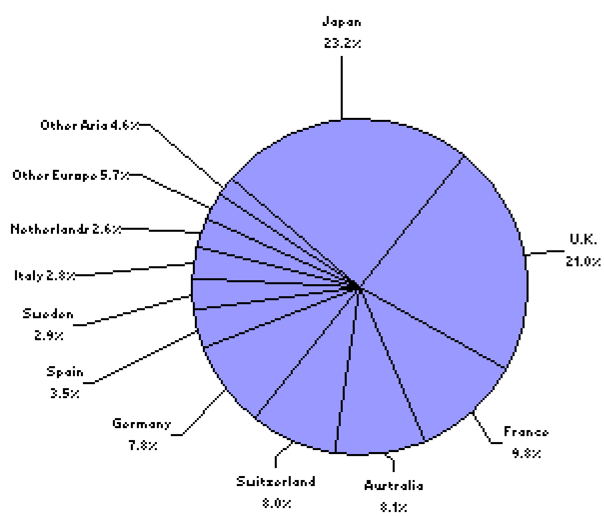
The MSCI EAFE Index (net dividend) declined -14.0% during the quarter vs. -11.4% for the S&P 500 Index. Emerging market returns were somewhat better than international large cap at -8.4% for the quarter. The stronger U.S. Dollar hurt returns and was the difference in returns between the MSCI EAFE Index and S&P 500 Index, as investors moved into the U.S. Dollar as a perceived "safer haven" as second quarter global events unfolded. Within the MSCI EAFE Index, the Pacific region outperformed the European region, as the European debt crisis continued to weigh on this region. The best performing countries were Singapore (0.0%), Denmark (-5.4%), and Hong Kong (-5.8%), while Greece (-40.5%), Finland (-26.4%), and Austria (-22.4%) were the laggards during the quarter. From an economic sector standpoint, Consumer Staples, Health Care, and Telecommunications were areas of strength, while Energy, Basic Materials and Financials were detractors from performance. The defensive sectors of the market performed the best. During the second quarter, the U.S. Dollar rose by approximately +9.5% vs. the Euro, +1.0 vs. the British Pound, but fell -5.0% vs. the Japanese Yen. Overall, the movement in the U.S. Dollar hurt our returns in the second quarter by approx. -2.8%.

The table below shows the performance of each EAFE country's national indices broken down between local market return and the USD return during the second quarter of 2010.

Return Attribution for EAFE Countries Second Quarter 2010

Country	Local Return	Curr Return	USD Return	EAFE Weight
Japan	-14.80%	4.70%	-10.10%	23.20%
United Kingdom	-12.70%	-1.20%	-13.90%	21.00%
France	-10.40%	-8.40%	-18.80%	9.80%
Australia	-12.00%	-7.00%	-19.00%	8.10%
Switzerland	-9.60%	-2.20%	-11.80%	8.00%
Germany	-3.70%	-9.10%	-12.80%	7.80%
Spain	-12.50%	-8.30%	-20.80%	3.50%
Sweden	0.30%	-7.50%	-7.20%	2.90%
Italy	-13.40%	-8.20%	-21.60%	2.80%
Netherlands	-4.10%	-9.10%	-13.20%	2.60%
Hong Kong	-5.60%	-0.20%	-5.80%	2.60%
Singapore	-0.10%	0.10%	0.00%	1.70%
Finland	-18.70%	-7.70%	-26.40%	1.00%
Denmark	4.50%	-9.90%	-5.40%	1.00%
Israel	-14.70%	-3.90%	-18.60%	0.90%
Belgium	-3.60%	-9.10%	-12.70%	0.90%
Norway	-10.30%	-7.80%	-18.10%	0.70%
Greece	-34.30%	-6.20%	-40.50%	0.30%
Portugal	-8.80%	-5.50%	-17.50%	0.30%
Austria	-14.30%	-8.10%	-22.40%	0.30%
Ireland	-11.40%	-8.40%	-19.80%	0.30%
New Zealand	-7.90%	-2.80%	-10.70%	0.10%
EAFE	-11.20%	-2.80%	-14.00%	100.00%

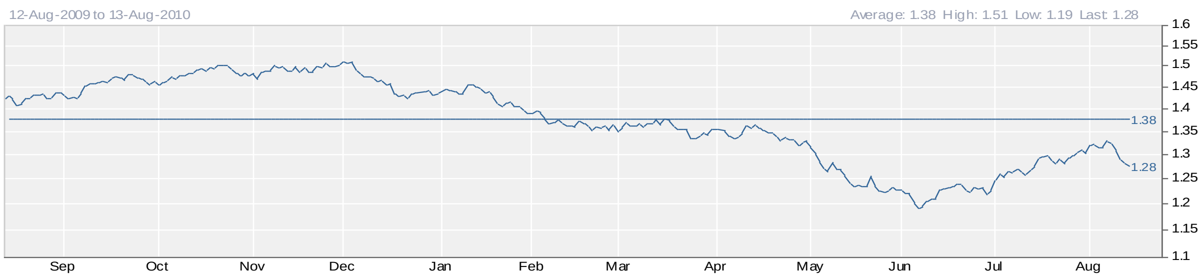
EAFE Country Weights as of June 30, 2010



Thus far into the third quarter of 2010, the global equity markets have moved moderately upward through mid August. News flow surrounding the European sovereign debt crisis has gotten much better on the margin and credit default spreads have tightened considerably with European sovereign debt. Aggressive monetary and fiscal actions have certainly helped this situation over the last couple of months. In addition, corporate earnings have been nothing short of spectacular. Companies are beating earnings and revenue expectations rather easily and at a pace almost never seen before. This is happening at a time when equity valuation levels looks attractive and the result has been an upward trend to the global markets in the early part of the third quarter. However, we do expect equity volatility to increase as investors are very nervous concerning their respective assessment of the 2011 economic outlook. This will no doubt shape the earnings outlook and the direction of the global equity markets over the next few months. There are a multitude of positive and negative data points to be considered and digested by investors.

Presented below are some charts showing the movement of various currencies:

USD per Euro



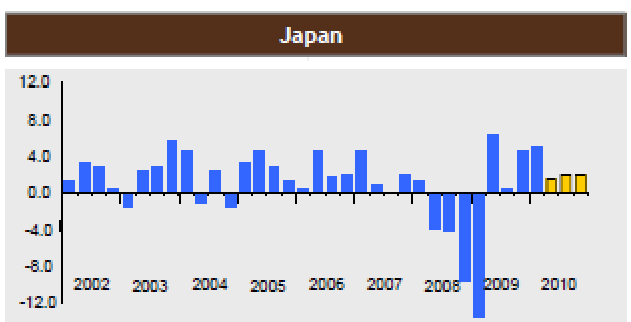
USD per British Pound

Japanese Yen per USD

Japan Update

Even though the Japanese equity market posted a negative return in the second quarter of 2010, it was the best performing equity market among the major markets in the MSCI EAFE Index. The further away from southern Europe you were, the better the equity returns seemed to be. The Yen continued to strengthen against the U.S. Dollar and provided a +5% benefit to our USD returns. With this in mind, we feel investors may have felt a bit more comfortable with this region relative to developments in Europe. However, the deflation debate continues in this region as the consumer has yet to really help this economy. The strengths remain in other sectors of the economy.

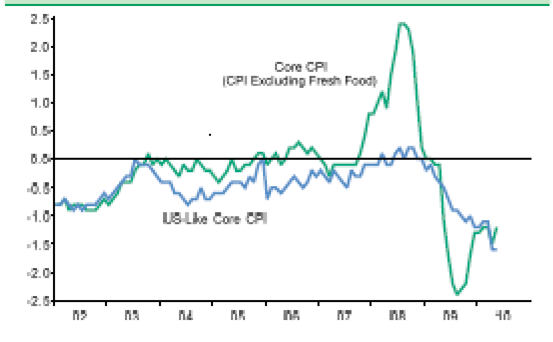
Second quarter 2010 GDP growth of just 0.1% from the first quarter, or 0.4% on a year over year basis, was a shocking surprise to the downside. This was the slowest level of growth in three quarters and the weakest among the big six economies around the globe. As a result of this weak report, China has officially taken over as the second largest economy in the world while Japan slips to third. This weakening growth stems from a cooling of the rampant pace of exports we have seen over the last nine months, in addition to a still weak consumer. Stimulus spending aimed at bolstering the economy could be moving into the later innings, which creates a bit of a headwind. This could put pressure on Prime Minister Naoto Kan's initiatives aimed at making progress on Japan's ailing fiscal condition as additional stimulus packages may need to be considered. Even though industrial production still continues to show nice gains from the depressed levels of 2009, it has cooled off from the first quarter, and was recently reported to be down over -1% in June from May. The rising Yen, which is at a 15 year high, is no doubt hurting exports. Slower expansions in the U.S. and China are also being felt. As a result, machinery orders rose less than forecast in June as capital spending remains very fragile at this point.



Source: JP Morgan

Consumer confidence continues to rise slowly and was recently reported at 43.6 in June, up slightly from the 41.0 reported in March. While this is a bit encouraging on the surface, we would have expected this to be higher due to the strength in the economy seen in most of 2010. We now fear as the economic slowdown begins to take further shape, consumer confidence could begin to turn southward. As always, the consumer needs to be a major factor in this economy as manufacturing looks set to cool off in the near term. The National Core CPI continued to fall in the second quarter, as prices fell approximately -1.2% from the year earlier period. We just have not seen much improvement here as this region seems to continue fighting deflation. Pricing pressure for most firms remains a serious issue. Japan's unemployment rate rose to a seven month high of 5.3% in June. This is in contrast to the jobs-to-applicant ratio, which improved to .52 in June from .49 in March. We feel the actual unemployment rate is a bit misleading due to conflicting reports on the size of the labor pool in addition to the somewhat lagging nature of the reading. Manufacturing jobs seem to be a bit more in demand than in other sectors; however, most are low skilled and low paying. Overall, we see further positive employment readings as tougher to come by if a more distinct slowdown comes to fruition in the third quarter.

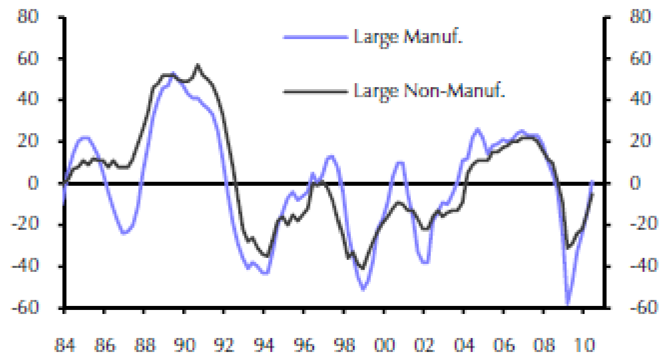
Chart 3: Core CPI (% y/y)



Source: MIC, BNP Paribas

Looking to the second half of 2010, we see the economy slowing down from the pace we have seen over the last few quarters. We hope this is more of a soft patch than anything else. The recovery is weakening from a slowdown probably going on in the U.S., China, and parts of Europe. Therefore, manufacturing remains a focal point of uncertainty going forward. As a result, the consumer will probably not be able to help much as this plays out. We expect the government to focus more on monetary policy actions to spur demand in addition to further stimulus actions, rather than fiscal measures dealing with Japan's massive debt problem.

3. Tankan Business Conditions

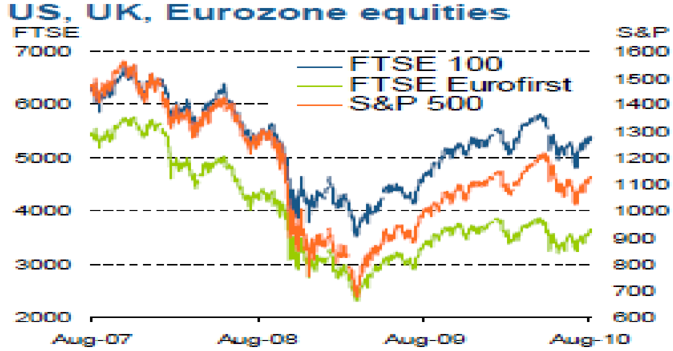


Source: Capital Economics

<u>Euroland Update</u>

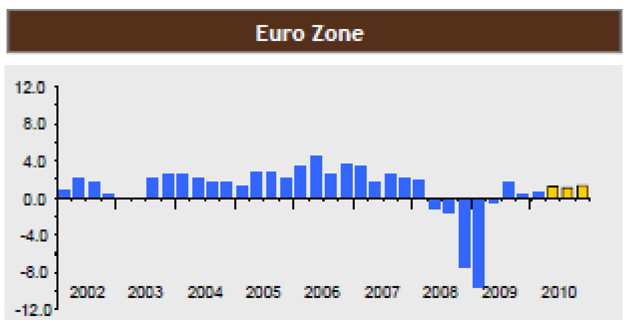
During the second quarter of 2010, the sovereign debt crisis remained the focal point, as a bailout package seemed to calm investors' nerves a bit and provide a near term band aid for the region. However, make no mistake; a long term fix will require much more fiscal discipline with pain to be taken by many. In addition, the impact of BP's massive oil spill in the Gulf of Mexico led to a sharp selloff in Energy related equities across Europe as investors fled these issues in an effort to distance themselves from this situation, not knowing just how bad things could become. These issues led to a "flight to a safer haven" in the currency markets, as the Euro finished down -9.5% against the U.S. Dollar. As a result, the MSCI European region (ex U.K.) was the worst performing major region in the index, finishing down nearly -16% in the quarter. Germany continued to benefit from the demise of other parts of Europe and remain the key catalyst to growth as the manufacturing sector benefited from the move in the Euro. Over the next few months, we will see much debate amongst economic leaders in Europe as to what measures need to be taken in order to address the serious debt debacle many countries are facing. As this debate transpires, we expect equity markets to be sensitive to these developments and move in a direction that reflects investors' perception as to any progress being made or lack thereof. This will be quite a political and economic challenge to say the least.

US, UK, Eurozone equities



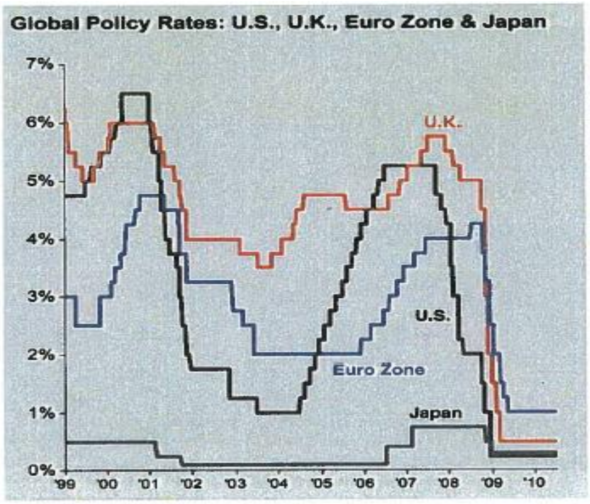
Indices updated to 6/8/2010. Source: FTSE, S&P, Nikkei, Ecowin.

Shaking off the Greek debt crisis, Euroland's economic recovery accelerated from the first quarter. The Euroland economy grew by +1.0% from the previous quarter, or +1.7% on a year over year basis in the second quarter of 2010. This is the fastest pace we have seen in approximately four years. Germany, with its large manufacturing base, took advantage of other countries woes as exports were quite strong. Germany still remains the pillar of growth in the region. The northern European economies continue to grow at a decent clip, while southern European economies struggle along from the effects of the debt crises. For the first half of 2010, exports to the U.S. are up nearly +10%, while Chinese exports were reported up over +40%. In addition, manufacturing capacity utilization recently rose to a two year high of 77.4 percent. With the recent movement in the Euro, European products are extremely competitive on world markets. The index of executive and consumer sentiment rose to 101.3 in July, the highest level in over two years. However, the consumer still seems to remain somewhat absent to the recovery party. Retail sales remained flat in June after increasing +.4% in May. We would have expected this to be somewhat better. A reluctance to spend is a telling reflection of the consumer's view toward the job market. Wage cuts and job eliminations are still a weekly event as corporations are using this in order to maintain margins.

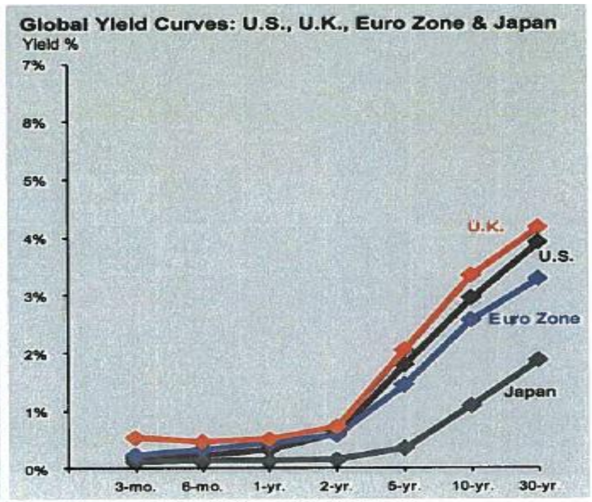


Source: JP Morgan

Coming as no surprise, the European Central Bank (ECB) has maintained its current view on interest rates and left its key refinance rate unchanged at 1% at its June, July, and August meetings. The ECB still continues to see inflation rates staying below their key limit of +2% over the near to medium term, as recent HCIP inflation was reported at +1.4% in June. This is even as the economy has been a bit stronger than many have anticipated as the recent debt crisis upheaval was dealt with. However, perhaps coming more into play as the broad economic weakening expected in the second half of 2010. The ECB feels growth rates across the region could fall just a bit as major trading partners begin to experience slower growth themselves. The pace of growth will be uneven as the global labor markets remain weak and fiscal policies could restrict some level of growth. They remain very concerned surrounding renewed tensions in the credit markets and the effect on consumers' spending patterns. However, when taking this all into account, their assessment of risk still remains broadly balanced, with a heightened degree of uncertainty due to the lingering debt crisis in the credit markets.



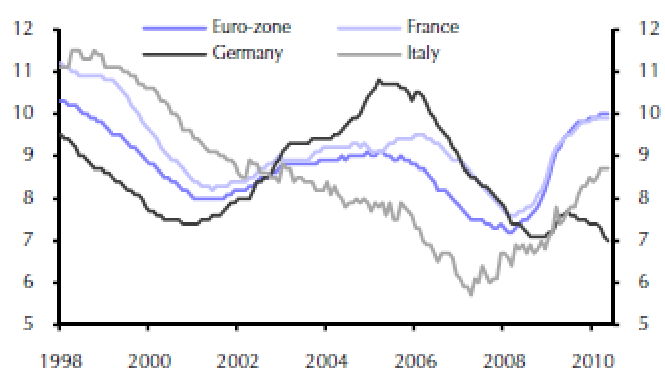
Source: FRB, Bank of England, European Central Bank, Bank of Japan, J.P. Morgan Asset Management.
Data are as of 6/30/10.



Source: Bloomberg, FactSet, J.P. Morgan Asset Management.
Data are as of 6/30/10.

Not much has changed regarding the employment outlook in the second quarter of 2010. Unemployment held at 10% throughout this time period and is still the highest rate in over a decade. There are approximately 15.8 million people who remained unemployed across the Euroland region. Spain still suffers from 20% unemployment while Germany saw its rate actually decline as manufacturing companies did manage to add some jobs in response to robust exports. At this point, with some level of growth weakness heading into the second half of 2010 for this region, we don't expect any real progress on this front. As we all know, this is the real key to sustainable economic growth.

Chart 4: Unemployment Rates (%)



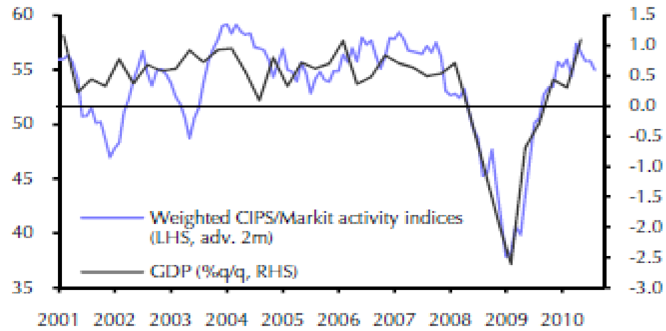
Source: Capital Economics

United Kingdom Update

While certainly nothing to be real positive about, the U.K. equity market did manage to outperform the Euroland equity markets once again in the second quarter of 2010. For the quarter, the U.K. equity market declined -13.90%, a little better than -16.00% seen in the Euroland region. Results would have been even better than this had BP not been crushed from the ongoing Gulf of Mexico oil well disaster. The U.K equity market outperformance stems from the stronger earnings recovery story in the U.K. relative to Europe as well as its perceived “safe haven” status during the sovereign debt crisis in southern Europe. In addition, a slightly higher dividend yielding market in the U.K. also benefited equities here relative to Euroland. However, we feel this outperformance will be coming to an end. With the new administration taking over, we see the U.K. government embarking on several rounds of fiscal “belt tightening” over the next few quarters. We see tax increases as well as large public spending cuts becoming a reality. We feel this is very necessary in order to contract government spending and make progress on deficit spending. As this unfolds, it probably spells a tougher climate for equities to perform well in and investors could shy away from the region as they look for opportunities outside of this area.

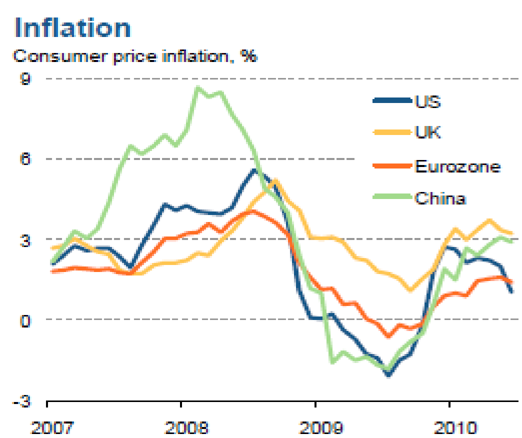
In the second quarter of 2010, the U.K. economy grew +1.1% from the previous quarter, or +1.6% on a year over year basis. This was much stronger than most analysts’ expectations. Overall, the recovery has been a bit stronger than what we have been expecting. The services side of the economy grew the most since 2007. Manufacturing posted one of the strongest quarters in ten years and construction surged by a brisk amount. The strength was very broad based in the quarter. Corporate earnings surprises were widespread as one would expect in the face of surprisingly strong economic growth numbers. Even though manufacturing was quite good, overall industrial production did slip a little in June as mining and utility output were a bit weaker than expected. Retail sales climbed +1.3% on a year over year basis in June, another sign the economy was strong in the second quarter. How much of this is from consumers coming out of a cold winter or a bit better news on the employment front in May is a little hard to pin down at this point. Supermarkets, department stores, and clothing stores all seemed to post good numbers. However, things could be tougher down the road. In July, consumer confidence slipped to the lowest level in over a year as consumers seem to be very worried about tax increases, their long term employment prospects, and Prime Minister David Cameron’s recent tough talk on addressing record deficits. With this in mind, we feel recent surprisingly strong economic numbers could be short lived as the future outlook gets cloudy from here.

Chart 1: Real GDP Growth & Business Surveys



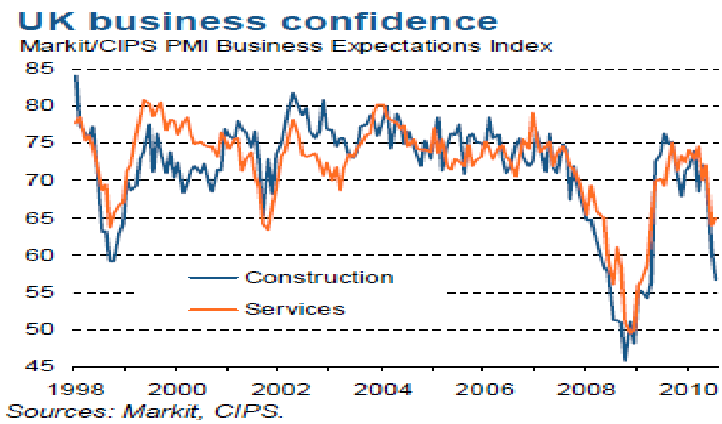
Source: Capital Economics

As we expected, the BOE held its key benchmark interest rate at 0.5% at its May through August policy meetings. In addition, the BOE held its asset buying program at the 200 billion pound level. However, the split among officials seeking higher interest rates widened in August, perhaps signaling a change may be ahead at some point regarding interest rate policy. This is probably in response to June's inflation report of 3.2%, which is above the government's 2% ultimate goal. Commodity costs, volatility in energy prices, changes in the Value Added Tax (VAT), and a near 25% exchange rate change are all contributors to the recent rise in inflation. The withdrawal of stimulus remains a delicate balancing act with no clear direction to a path of least pain. In a bit of good news, the unemployment rate fell to 7.8% in the three months ending in June, which is one of the fastest paces in many years. The number of people seeking work fell to 2.46 million from over 2.5 million the previous quarter. In addition, people claiming jobless benefits fell in the second quarter to 1.46 million. While this is certainly good near term news, a longer term problem still remains as Prime Minister David Cameron is looking for the private sector to add over half a million jobs over the next few years as he seeks massive government job cuts. Doing this in a weak economy will be very difficult to do.



Source: Markit

We feel the recent good economic news from this high growth region in the second quarter will not continue over the next several months. Indicators seem to be pointing to the second quarter economic performance as a near term cyclical high point with weakness ahead. Fiscal policy considerations will take over as the government attempts to make progress on the record deficit problem. As this unfolds, pressure on consumer confidence will continue as further tax hikes will be necessary. This could make this economy even more fragile than ever and make the job of the Monetary Policy Committee (MPC) even more difficult. We would expect equities to have a difficult time performing well in this kind of environment.



<u>International Equity Activity/Strategy</u>

While we have passed the near term high point with the European sovereign debt crises, many key issues remain for investors to wrangle with in the coming months. Clearly, the global economy does appear to be weakening from the rapid pace of recovery we have seen, but will these lower levels of growth be enough to calm investor nerves and push markets higher. Below are many of the issues that we see that could come into play and shape the direction of the global equity markets.

- Will growth slow down to the point of a possible “double dip” recession?
- Much tougher growth for corporate earnings as revenue growth could be pressured at the same time as costs creep back into play.
- Inflation/deflation debate.
- Lackluster global employment growth.
- Restrictive fiscal policies.

- Can China engineer a somewhat "soft landing" in this high growth region.

- Structurally high deficits.

Obviously, negative news on these fronts can send equity markets south in a hurry. However, there are many items to point to which are conducive to a better equity environment such as: low inflation, record low interest rates, housing potentially getting better on the margin, decent equity valuations, healthy corporate balance sheets, merger and acquisition activity, and the Emerging Markets story. Ultimately, how these issues come into play over the next few months will determine the strength and or weakness of the global equity markets.

We have recently added approximately $150 million to our Emerging Markets Index (EEM) through a recent put option assignment. We feel this is an attractive way to selectively add exposure to this segment of the market. This strategy gives us a better potential entry point with the EEM as this index is subject to a heightened level of volatility as macro events unfold around the globe. We continue to like the idea of tactically increasing our exposure to this index as we feel the growth prospects in these regions will be some of the best around the globe for years to come. Our total allocation to international equities is approximately 14.15% of total TRS assets, 13.1% of total ERS assets, and 14.7% of the JRF total assets. *(Charts provided by Factset, William Blair, Capital Economics, Wachovia/Wells Fargo, JP Morgan Asset Mgmt, Thomson Datastream, Markit, CIPS, FRB, ECB, Bank of England, FTSE, Nikkei, S&P, Bloomberg, Ecowin, MIC, BNP Paribas, ISM, Bank of Japan)*